



THAILAND ECONOMICS

REFORM AT A STATELY PACE

Reform at a stately pace

Thailand is coming back. You would never know this when scrutinising the details. Rescheduling is occurring without restructuring. The government is unable to spend its stimulative budget. Miyazawa funds are being wasted. Privatisation is languishing. Protected refining, petrochemical and steel firms are reducing Thailand's competitiveness in exactly those industries — vehicles, white goods, machinery — that offer hope of future national growth. Reform seems subordinated to politics. Korea's decisiveness is absent.

And yet, economic recovery is broad-based. Improved confidence is palpable. First-quarter growth was 0.9%, and second-quarter numbers are likely to be much better. With interest rates at a modern low, the economy is awash with liquidity. Capacity utilisation and manufacturing production are rising. Real purchasing power is rising, and businesses are beginning to re-stock. Monthly vehicle sales are up 50% from their low. Sales of white goods, consumer durables, and department store items are rising. Agriculture is recovering from drought. Low-level housing is recovering, though commercial property still has a huge overhang. Corporate tax collections are 50% over budget. Exports, foreign direct investment, and tourist arrivals are up.

Despite the delays, economic reform is happening. The assets of the closed finance companies have been mostly sold and are back at work. Thailand's original 15 banks seem likely to be reduced to six. Increased foreign bank participation will enhance competition and credit standards. Bankruptcies and foreclosures now happen, and fear of them is changing the way Thailand does business. It turns out Thailand doesn't need that many new accounting laws; it needs enforcement of the old ones, and badly burned banks are beginning to do that without government help. Not everything is improving, of course. Don't look for improvements in corporate governance.

Underneath these business improvements, Thailand's entire institutional structure is being renovated. The country has a new anti-corruption constitution. Prime Minister Chuan's Democrats are a new kind of political party that is changing the nature of Thai politics. There is a new professionalising Thai army whose chief takes pride in staying out of politics. The emergent banking system will be far more open, competitive and professional. Above all, new legislation on freedom of information is changing the way the civil service, the parties, the bureaucracies, and the banks and corporations do business.

This systemic renovation is addressing the great weaknesses of Thai society, namely its corruption and elitism. And it is enhancing the strengths that created the original economic miracle. Thailand grew faster than other emerging economies because it was more diverse, more competitive, and had freer access to information than its competitors. The new Thailand will be even more diverse, even more competitive, and have even freer access to information. Thailand's diversity is the enemy of Korea-style clear-cut, top-down decisions, but its messiness is the messiness of the market.

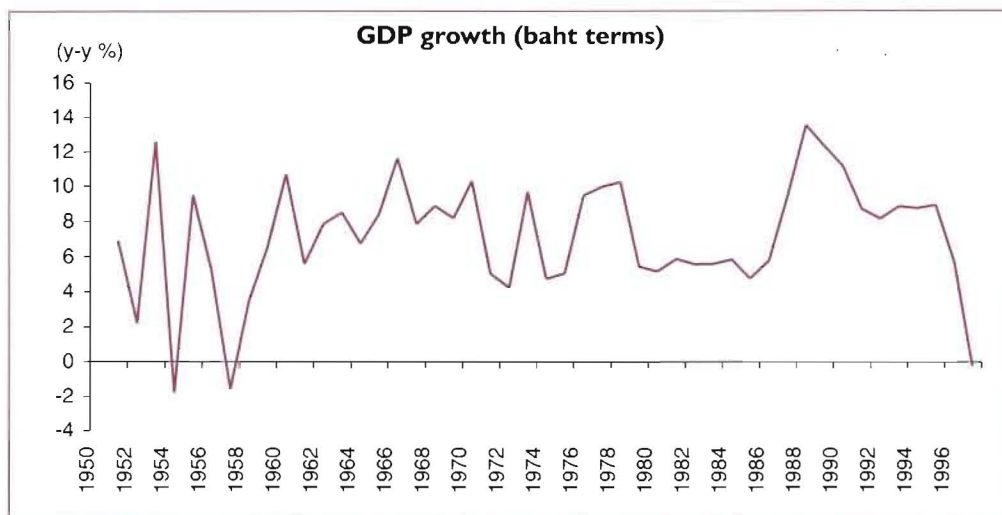
Our 1999 Thai GDP growth forecast is 2.5%. For a long time, this has been the highest forecast in the market. Now the consensus is moving up. Our 2.5% growth projection implies 85% earnings growth. And higher is possible. (For more on this, see the Thai Research Team's *Thailand outlook: All geared up for recovery*, 7 July.)

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The economic miracle

By the late 1980s, Thailand had emerged as the leading country of Southeast Asia, based on its substantial size and on an economic miracle that was more free of recession than virtually any other economy on earth. It is worth revisiting these virtues because one can then assess the extent to which the present crisis has fundamentally damaged them, exposed them as false, or perhaps even strengthened them. A central theme of this report is that Thailand must be judged on its own terms; its virtues and vices are very different from those of South Korea and other Asian countries.



Source: IMF, International Financial Statistics

Miracle based on diversity

Thailand's economic miracle resulted from size, governability, and diversity. It is a manageable country, with land area and population about the size of France (61m people in 1997) and manageable ethnic diversity. It is smaller than Indonesia, but has far fewer troublesome religious and ethnic divisions; poorer than Singapore but with a size that gives it more gravity; initially far poorer than the Philippines, whose roads and education had been bolstered by a colonial power, but more proud, more mature, and ultimately more successful in building itself.

Messy but competitive economy

Thailand's economy and politics have proved nearly incomprehensible to foreigners. Both are messy but efficient. They are messy because they are diverse and competitive. They are efficient in key ways because they are diverse and competitive.

Diverse products

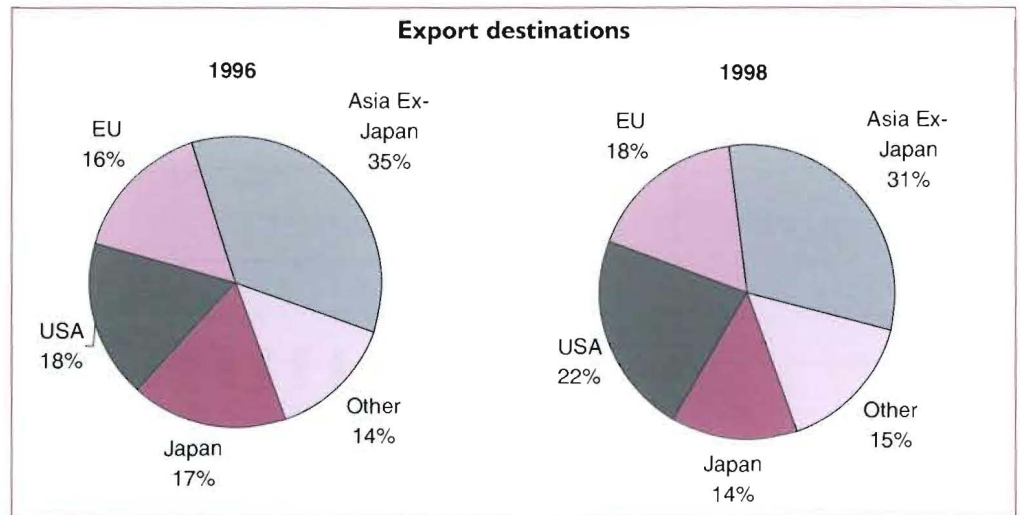
The economics of diversity and competitiveness is easier to comprehend than the politics, since almost all of market economic theory is about diversity and competition. What is vital to remember in Thailand's case is just how diverse and competitive the economy is. Thailand is the world export-leader in rice, tapioca, canned pineapple, and cut orchids; the world's leading gem-cutting centre; and one of the three top exporters of tin, shrimp, and rubber. All of this has led most investors to think of Thailand as a particularly diverse exporter of raw materials. But more than half of Thailand's exports are manufactured goods. Semiconductor and computer part production has grown very rapidly. Thailand is the principal regional production centre for almost all important regional manufacturers of cars and trucks. Industrial exports themselves are very diverse.

Diverse ownership

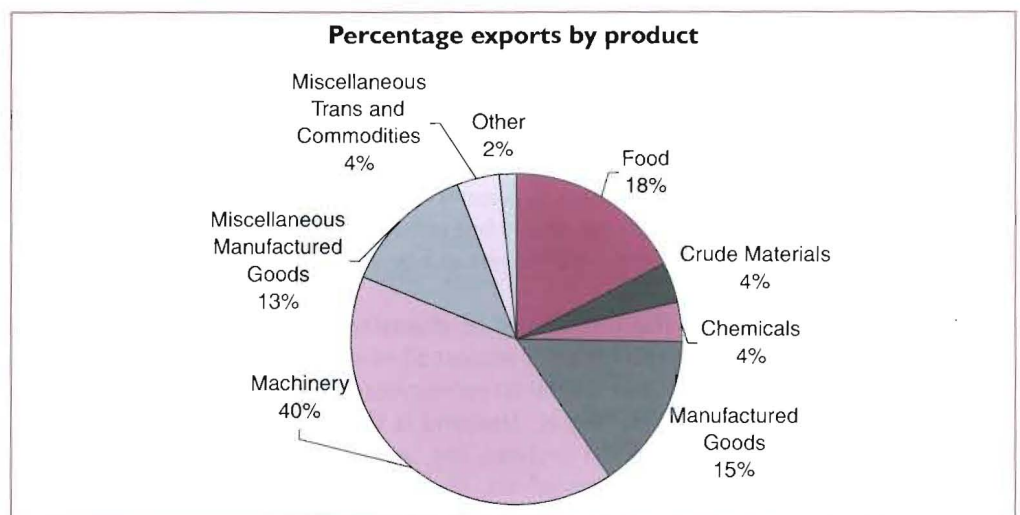
Not only are the economy's products diverse, ownership is diverse. This is no Philippines or Indonesia, where a few families control all the interesting sectors of the economy. Nor is it even a South Korea, where half a dozen firms control half of the economy, including all the most interesting sectors. Foreign direct investors have flocked to Thailand, where they are treated more fairly and openly than in competing countries such as Indonesia, Malaysia, and South Korea. This is a big country with great diversity of ownership. If Brazil had sound budget management and a social structure based on small agricultural holdings rather than giant haciendas, Brazil could have been like Thailand.

Diverse markets

And, vitally, Thailand's foreign markets are highly diverse. Its domestic market is far more important than the domestic markets of the other fast-growing Asian economies, and its export markets are far more diversified.



Source: CEIC



Source: CEIC

Diversity implies efficiency, growth and resilience

The consequences of such diversity can be read in any economics textbook: efficiency, growth, resilience. To put numbers on this: Thailand's economy had nearly four decades of growth averaging around 7% per year. This is about three times the growth rate that created the great economic powers of today's world. In four decades prior to 1997, its growth rate never dipped below 3.7%; that is to say, its lowest growth rate roughly corresponded to the highest level normally attainable by a Western country. And it adapted to changing world markets with remarkable aplomb: witness its plunge into tapioca and soybeans when opportunities appeared, or its quick adaptation to the Third World financial crisis of 1982. All of this made it seem like a recession-proof economy — until 1997.

The political picture: diverse and competitive

Political diversity and competition are familiar in the West. But Thailand has never until recently been a strict Western-style democracy. So some people tend to think of Thailand as either a half-baked democracy (in its liberal periods) or just another Third World dictatorship (in most of its modern history, including most recently the late 1970s). But neither of these models fits. If it is half-baked, why does it grow so fast and why does it never have big explosions like the Philippines? If it is periodically just another dictatorship, why are things so messy, with leaders changing all the time and all sorts of interest groups getting their way in a fashion that Korean governments would never tolerate?

We believe it is best to use economic models to think about Thai politics. Diversity and competitiveness have consequences in Thai politics similar to those they have in Thai economics.

Political diversity and...

Thai politics is very diverse. Regardless of this year's form of government, or the latest leadership shuffle, a number of groups always have a big say in governing Thailand: the political parties, the military, the monarchy, the civil service, the middle class, the banking aristocracy, and the intellectuals. Buddhist clergy and farm groups occasionally weigh in, too.

All these groups have substantial power bases. They can maintain their power bases for three reasons. First, diverse ownership of the economy means no single group can get a stranglehold on the economy and use that stranglehold to create a political monopoly. Second, over many generations Thailand developed its banking system, its civil service, its military, and its monarchy into institutions with a tradition of competence and integrity, notwithstanding a good deal of graft. The ability of the civil service to manage the economy for uninterrupted growth and uninterrupted financial soundness gave it prestige and a guaranteed political role. Third, everything in Thailand's social makeup, religion, and historical experience has taught it to tolerate diversity. Thai Buddhism is a distinctive compendium of the virtues of tolerance and diversity.

...political competence...

For several decades the relative competence of Thailand's basic institutions distinguished it from most Third World countries. While the recent crisis has exposed important limitations, Thailand's ministries, its central bank, and its military developed a degree of autonomy, competence, and integrity before a majority of other Third World countries.

Thailand's diversity further distinguishes it from these high-powered Asian competitors. Diversity creates certain virtues:

...prevent monopolies...

With all this diversity, no group can obtain a political monopoly. No Marcos or Suharto or Chun Doo Hwan can ever retain power in Thailand.

...and create an inclusive system

With all this diversity, no group can ever be completely excluded. Diversity creates competition. Every group with a share of power is always at risk of losing part of its share. Every group is therefore always looking for allies. As a result, when social change creates a newly important group, such as the middle class that emerged from economic development in the 1960s and 1970s, there are always insider groups struggling to obtain the newcomers as allies. This has created an inclusiveness that is the opposite of what happens in most Third World countries. In the Philippines or Indonesia or South Korea, the insiders make a desperate effort to keep an emergent group from claiming any share of power. So when a middle class emerges, there is long-term repression followed by explosion. In Thailand, everyone with any resources quickly becomes an insider.

*Competition creates
competence*

Competition among groups also creates political competence, as in the economy. Thailand's political leaders are arguably superb at managing shifting coalitions and balancing diverse interests. The military develops similar skills; Thailand defeated its Communist Party not so much by brute military force as by political sophistication, and when they were needed the generals were as sophisticated as the politicians. Moreover, because of the premium placed on the politics of diversity and balance at home, Thailand has always possessed the same skills in foreign affairs; Thailand preserved itself from colonisation, and later from being crushed by the Cold War politics surrounding the Vietnam War, by sheer mastery of the politics of diversity and balance — that is, by political competence. At home and abroad, Thailand has traditionally displayed the balance of a ballet dancer.

*Competition and
diversity create freedom*

Finally, the politics of competition and diversity creates freedom. With so many groups able to share power and express their interests, no group can muzzle other groups. Thailand welcomes Buddhists, Muslims, Christians, and others. Thailand has the freest press in Asia outside the Philippines — and the Thai press is arguably a good deal more professional than the Filipino press. There is nothing in Thailand like Singapore's occasional banning of the *Far Eastern Economic Review*, *Asiaweek*, and the *Asian Wall Street Journal*. Freedom helps maintain political stability by creating a relaxed atmosphere and by ferreting out wrongdoing. And it helps business by maintaining a free flow of information.

These virtues have facilitated consolidation of Thailand's democracy, which is now more stable than at any time in Thailand's history, despite the crisis. They have facilitated a truly national response to the crisis, despite what appears to be weak leadership.

The crisis of 1997

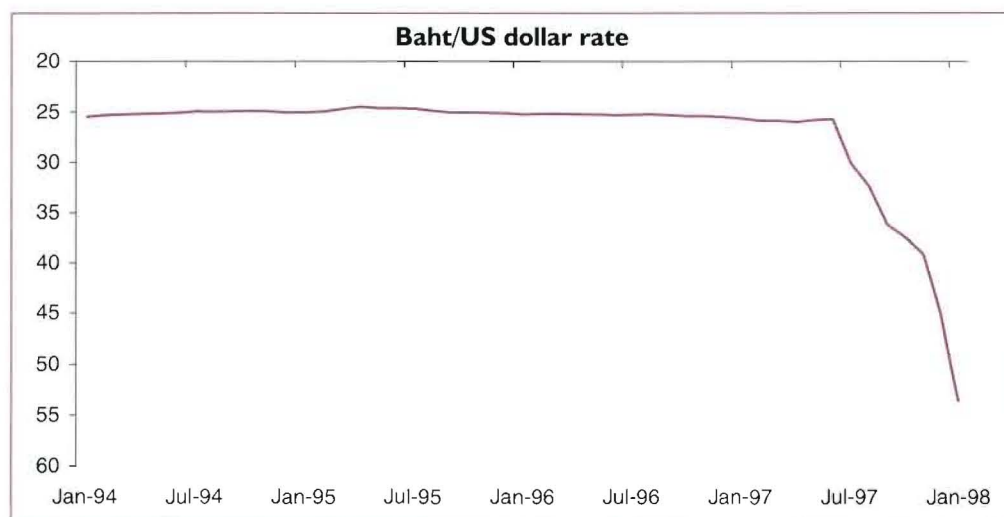
The surprise crisis

With all these virtues and such a long history of economic success, the crisis of 1997-98 took Thais and outsiders by surprise. The crisis revealed that institutional competence has been severely compromised by corruption and failure to coordinate, that diversity and multiple power bases mean slow and inconsistent responses to national danger. Notwithstanding that surprise, the principal virtues of the Thai system, namely diversity, competition, and free flow of information, remain and are being strengthened by the current reformist government. Thai virtues are in some ways the opposite of the South Korean virtue of strong leadership, strong government control of the economy, and this leads to unfavourable comparisons of Thailand with South Korea. Moreover, Thai virtues are messy, and in difficult times that messiness conveys an image of confusion and lack of direction that can appear to be unmitigated weaknesses. They certainly do make it impossible for the economy to turn on a dime, but the central thesis of this report is that, if the reform process continues on its present course, Thailand's virtues will be substantially enhanced and its weaknesses greatly reduced. Thailand should then resume its role in the vanguard of emerging markets.

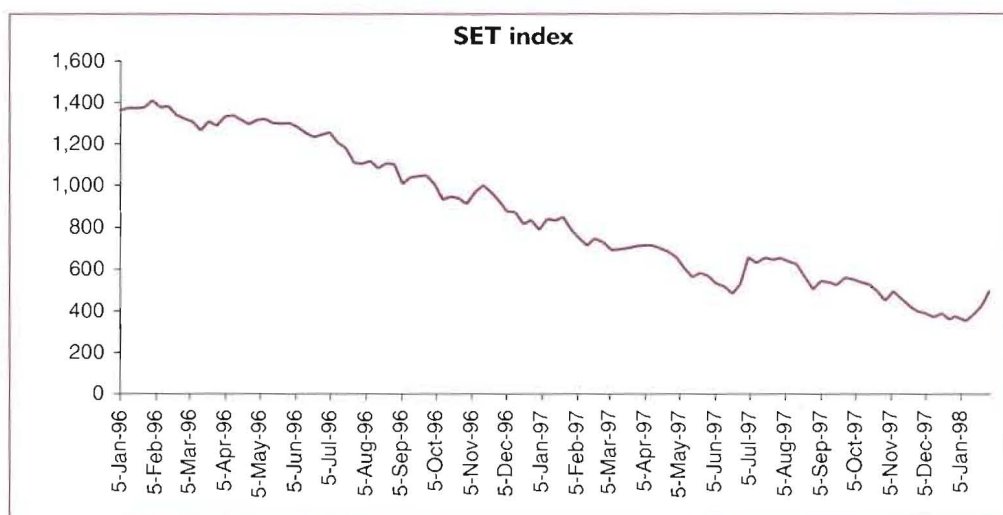
On the other hand, in the far less likely but not impossible scenario that the reform process is disrupted by political incoherence, then Thailand's great weaknesses of elitism and educational impoverishment could reduce it to a Latin American backwater.

The dimensions of the crisis

In the crisis, the currency plunged from THB24.53:US\$1 in April 1997 to a low of THB53.74:US\$1 in January of 1998. The stock market declined from 1,415 points on February 14, 1996, to a low of 207 on September 4, 1998.



Source: CEIC



Source: CEIC

Fifty-six finance companies, more than half of all finance companies, had to be closed, and the entire capital of the banking system was wiped out. Virtually half of all bank assets turned into non-performing loans. Some 69,000 companies went into debt restructuring, and two-thirds of all Thai companies were left with no capital. An economy that had appeared almost recession-proof lost over 9% of GDP in a single year. Under modestly optimistic assumptions, the crisis looks set to cost the Thai economy the equivalent of five years of growth.

The roots of crisis

A bubble crisis

The Thai crisis has been described as a currency crisis, as the consequence of speculative attacks, as an artifact of premature liberalisation of capital flows, and even as a crisis of Asian values. While there were elements of all these, the real roots were both simpler and more complex. In financial terms, a system that had for decades been managed with financial conservatism and competence — for instance, with government budget surpluses and limited foreign debt — quickly developed a huge domestic real estate bubble and an unsustainable level of short-term foreign debt.

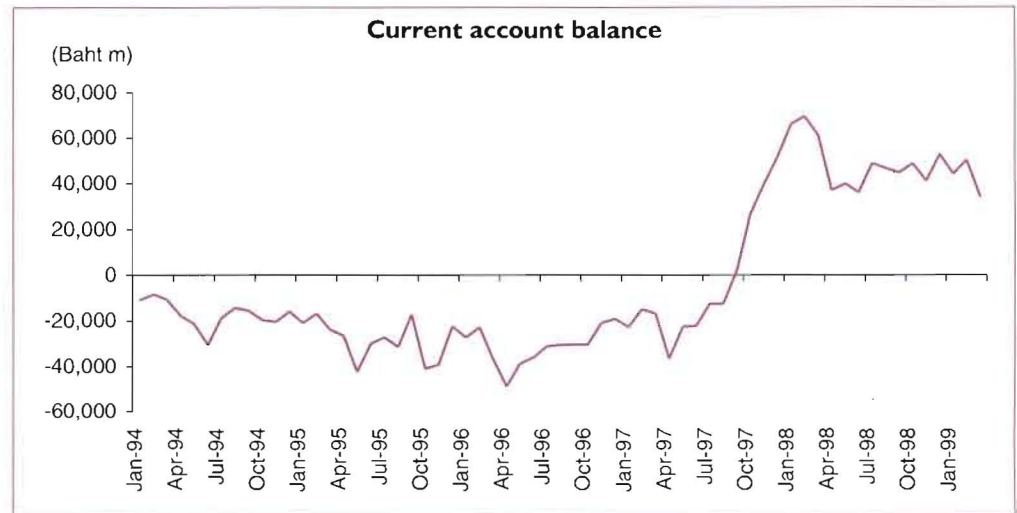
The bubble meant profit-less investment

In retrospect, the symptoms of trouble long predated the crisis itself. Even the current account imbalances that first aroused the interest of speculators were a relatively superficial symptom. As shown in the chart below, in the three years prior to the baht devaluation of July 2, 1997, earnings growth had disappeared from an economy that previously, except for rare and isolated years of global economic stress, had exhibited exceptional earnings growth. The 1995-97 squeeze occurred at a time of global economic abundance and liquidity. By 1996, which started with the usual optimistic estimates of earnings growth, the collapse of corporate earnings began to be acknowledged, as indicated by a 35% decline in the stock market. The Thai system had lost the ability to allocate capital efficiently. The emerging financial bubble meant huge but profitless investment.

Thailand market and sector corporate EPS growth

All stocks	Total market (%)
1988-89	17.4
1989-90	26.9
1990-91	10.3
1991-92	17.5
1992-93	-5.9
1993-94	17.4
1994-95	3.6
1995-96	1.2
1996-97	-48.2
1997-98	172.1

Sources: Datastream (historical), The Estimates Directory (forecast), Nomura International Quantitative Research



Source: CEIC

*Current account deficit:
8% of GDP*

Simultaneously, Thailand developed a current account deficit that eventually ballooned out to 8% of GDP. This deficit reflected the same phenomenon as the collapse of corporate earnings growth — the inefficient deployment of capital increased imports of non-productive capital goods and consumption while failing to contribute proportionately to production and exports.

*The crisis began in
1995-6, not 1997*

The Asian crisis is usually dated to the collapse of the Thai baht on July 2, 1997. More properly, it should be linked to the general collapse of earnings in 1995, the collapse of Bangkok Bank of Commerce and finance company problems in 1996, the crumbling of the Thai Bills of Exchange market after July 1996, and the February 1997 default by Somprasong Land Plc (delisted), a major Thai property company, on its Eurobond. Somprasong Land was the first Thai company to default on a Eurobond, and the default marked the point at which the Thai real estate bubble began to pop. The Bangkok Bank of Commerce collapse first revealed the extent to which the regulatory system was refusing to confront the problems emerging alongside bubble profits.

*The property bubble
was big in 1995, huge in
1996*

The real problems began much earlier than 1997. By 1995, Bangkok residential property had a 40% vacancy rate. Vacancy rates for retail space doubled in 1996 to 14%. In 1996, demand for office space had been 550,000 square metres and declining, while builders of office space had committed to construct 1m sq m per year for each year through 2001. In 1996, 4,700 condominiums were sold while 12,500 remained unsold and 21,900 were due to be completed in 1997¹. Bangkok Land (BLAND.BK, THB9.60, not covered) had effectively built whole suburbs of apartments that became ghost towns for lack of demand. In March 1997, 60% of all newly completed office space remained vacant. Despite this huge oversupply, prices had remained relatively flat. At some point, supply and demand were going to converge, squeezing the bubble and popping it with a bang that would shatter the entire economy and financial system.

*The government did not
respond*

"By 1995," according to one of Thailand's most distinguished scholars, "everyone knew that the property sector was overbuilt." There were numerous minister-level comments about the risks of the property bubble. But nobody did anything, and so far as is known nobody recommended any strong actions. The entire elite was making huge amounts of money. Many, perhaps a majority, of the country's leading political figures had direct interests in finance companies and property companies. Of course, nobody had any idea how serious the consequences of a bust would be, but the likelihood of an eventual bust was no secret.

¹ See Jones Lang Wootton, *Bangkok Property Outlook No. 4*, January 1997, and Kim Maire, *Thailand — Financial Services Industries*, U.S. Embassy, Bangkok, March 1, 1997, in National Trade Data Bank. Some of this analysis was included in this writer's January 1999 survey of the regional crisis (*Asia's Bubble Crisis: No Instant Cure*) but is expanded here.

The Bills of Exchange market collapsed before the forex market

Even before the real estate bubble itself burst, it came under pressure and related bubbles started bursting. Thailand had a multi-billion dollar market for Bills of Exchange, comprising 90-day paper issued by local corporations and guaranteed by local finance companies for purchase by banks. The trouble started in June of 1996 when it became clear that Thai Granite (delisted) would have difficulty servicing its Bills, which were guaranteed by a finance company called Thaimex. When it became clear that eventual default was likely, a major US bank made preliminary moves to invoke its guarantee, and it became clear that under Thai law Thaimex would be able to stall payment indefinitely. After the actual default occurred in July 1996, other foreign lenders studied the situation and discovered to their horror that under Thai law all finance companies could avoid paying virtually indefinitely. This writer's research staff of the time published a warning of what was to come in August 1996; by October 1996, when three defaults were under way, the more savvy banks were abuzz with concern that the entire bills market had no foundation. There ensued a process of slow-motion collapse, creating huge losses for foreign banks and their customers². In the autumn of 1996, Moody's downgraded Thailand's short-term sovereign debt rating.

NPLs were skyrocketing by 1996

The problems were not confined to foreign banks and foreign loans. By the summer of 1996, non-performing loans at Thai banks were up to a high (for normal times) 7.7%, and by early 1997 some analysts were expecting that number to double³.

Banks realised they lacked basic protection...

Following all this, foreign lenders gradually became aware of a much broader point about the position of banks and other creditors in Thailand: under Thai law creditors effectively had no way to seize assets that had been placed as collateral for loans to debtors who subsequently defaulted. During February 1997, this writer's research staff held a seminar in Bangkok where a local lawyer appraised shocked foreign investors of their almost complete inability to recover substantial assets from Thai companies that defaulted on loans or bonds. In May 1997, holders of bonds issued by Alphatec (delisted), Thailand's most prestigious high-technology firm, discovered not only that the company could not pay but also that its accounting practices, facilitated by local practices which tolerate a high level of opacity in financial reporting, had enabled it to publish accounts, audited by one of the world's most prestigious accounting firms, which turned a huge loss into a large profit (US\$128m of "false profits") and concealed the transfer of at least THB3.95bn to related parties without permission of the board of directors⁴. On reflection, it became obvious to the banks that such practices were widespread and that foreign investors were vulnerable to huge losses from situations like that of Alphatec.

...so they exited

The result of all this was a massive exodus of foreign bank loans and fixed-income investors from Thailand and a historic financial crisis. Banks realised three things simultaneously: that a popping bubble was endangering a wide range of even the most prestigious Thai companies; that lack of transparency in company accounts under prevailing Thai regulations obscured the real financial status of their customers; and that Thai bankruptcy law failed to provide most of the customary protections to creditors.

² See Aaron Henderson, "Thai Bills of Exchange: Storm Warning" (August 1996) and "The Thai Finance Sector: The Storm has Begun", (October 1996), in *Asia Window*, Bankers Trust Co.

³ Kim Maire, op. cit.

⁴ "A decidedly old-fashioned windfall," *Financial Times*, July 29, 1997.

*A bubble, not an
irrational bank panic*

A great bubble-popping would have occurred under any circumstances. It happened that Thailand's bubble of overpriced real estate and overextended banks was inflated primarily with foreign currency, but this fact was secondary. China and Japan had bubbles, too, but those bubbles were inflated almost entirely with local currency. The economic consequences of a bubble are similar regardless of whether the inflation is done with domestic or foreign currency: the bubble sector (predominantly real estate in Thailand and Japan, predominantly industrial conglomerates in China and Korea) implodes, companies in that sector become unable to pay their loans, and this threatens to bankrupt the banks. In Thailand's case, the bubble was largely inflated with dollars and the sudden need to repay all those dollars created one of the great short squeezes of modern history and temporarily doubled the price of dollars. This dramatic effect led to the almost universal perception that the core problem was a currency crisis. It wasn't. The crisis was a simultaneous real estate bubble collapse and realisation by banks, domestic and foreign, that their customers were not creditworthy. Contrary to arguments by Jeffrey Sachs and others, this was not an irrational bank panic.

*Exchange-rate stability
was valuable...*

The inflation of the bubble with foreign exchange resulted from peculiar financial arrangements whose political origins are instructive. Thailand maintained relatively high interest rates to contain inflation in a booming economy, and it controlled the exchange rate in order to stabilise trade prices and limit inflation. This combination worked very well for many years. The economy achieved very high growth with very modest inflation. Trade increases much faster when prices are highly predictable, so trade price stability was quite valuable for this reason as well as inflation control, and trade drove Thailand's rapid growth.

...but triggered arbitrage

But then Thai authorities gradually allowed a freer flow of foreign exchange. Arbitrageurs naturally borrowed dollars at low interest rates and turned them into baht to earn high interest rates. Knowing that the currency was controlled, they were confident that they could convert their earnings back into dollars without fear of loss. Soon individual banks were doing this on a scale of several hundred million dollars each.

*The BIBF was conceived
for international
purposes...*

This process was hugely accelerated by a unique Thai institution, the Bangkok International Banking Facility (BIBF). At the beginning of the 1990s, Thai leaders imagined that Bangkok could become a competitor of Singapore and Hong Kong as an international banking centre. This was far-fetched because of Thailand's poor communications and poor financial transparency, but the dream was potent and it had some limited feasibility as applied to neighbouring Indochina. In order to compete, they legislated in September 1992 to allow banks licensed by the BIBF to take deposits and lend in foreign currency for foreigners at highly preferential tax rates. Corporate income tax would be 10% rather than 30%, while the stamp duty, 3.3% business tax, and 10% withholding tax would be waived completely.

*...but lobbyists made it
domestic, with BoT
encouragement*

As initially conceived, this would not have contributed to the creation of a great domestic financial bubble because all the deposits were to be taken from foreigners and all the lending was to be to foreigners — so-called “out-out” banking. But Thai banks, one of the most potent political forces in the Kingdom, lobbied to be allowed “out-in” banking also. They succeeded, and in March 1993 all 15 domestic banks plus 32 foreign banks were licensed by the BIBF. Bank of Thailand (BoT) unofficially encouraged foreign BIBFs to maximise their lending by telling foreign banks that some BIBFs would be upgraded to branches and the lucky ones would be chosen at least partially on the growth of their BIBFs' assets. Foreign banks, long denied the opportunity to create new branches in Thailand, seized the BIBF opportunity more to expand their presence in the Thai market than to use Bangkok as an international clearing house. Thus political lobbyists transformed the BIBF into something quite different from what its creators had intended.

*The BIBF hugely
accelerated inflation of
the bubble*

The resulting channel for foreign exchange to enter and exit Thailand created one of the great bubbles of financial history. Foreign money went into Thailand's finance companies and banks in huge quantities; they in turn channelled it to property developers, who built frenetically even when the market was exhausted, and into numerous other businesses with little hope of financial return. The consequence was a collapse of corporate earnings growth, of the current account balance, and of the creditworthiness of the entire Thai financial system. The BIBF structure, inaugurated to turn Bangkok into a leading international financial centre and to enhance the profits of Bangkok's leading banks, combined lethally with high domestic interest rates and the pegged currency; the combination took just four years and four months to turn Bangkok into the financial equivalent of Hiroshima⁵. In April 1999, according to BoT data, 47% of all loans at banks and finance companies were not being paid.

The deep roots of the crisis in the Thai financial system and property bubble belie the common interpretations of the problem as primarily currency contagion, of foreign speculative activity, of domestic banking regulatory failures, or of a foreign banking panic. There were of course elements of all of these, but the central problem was a financial bubble caused by institutions that channelled huge amounts of foreign capital into a limited economic space.

⁵ The US Embassy reported on September 23, 1992, that bankers regarded the BIBF as a useful first step but too small to generate significant activity. They particularly criticised the BIBF rules as doing too little to stimulate foreign borrowing for domestic Thai investment. See *Thailand — Offshore Banking Regulations*, National Trade Databank, Amembassy Bangkok. This is one of the more spectacular financial misjudgments of modern history. In fact BIBF generated more than US\$8bn of loans in the last nine months of 1992, US\$17bn in the following nine months, and continued to grow exponentially.

Response to the crisis

Restoring reserves and currency stability

In the midst of financial crisis, a time-out for politics

The Thai response to the crisis was peculiar. Although they followed the IMF programmes and dealt with their failed finance companies and collapsed foreign exchange reserves, the Thais basically declared a time-out at the end of 1997 and focused on writing a new constitution. In other words, financial crisis management was done, but economic issues were regarded as having lower priority than political reform. There was a surprisingly broad consensus that the foundation of economic reconstruction had to be political reform. Although it may initially seem strange to put Thailand's reaction to crisis in the same perspective as Indonesia's, the two countries shared a feeling that fixing the economy was secondary to fixing the politics. Thailand made gentler changes, using elections and legislation rather than riots, and the crisis management of Thailand's economy was far more competent throughout; but nonetheless, despite the many years of economic success the two countries had enjoyed, Thailand shared Indonesia's revulsion over the way the economy had been managed, it shared the determination to make fundamental changes, and it shared the sense that financial crisis management without political reform was a waste of time.

Because of this, one cannot properly comprehend the Thai response to the financial crisis without putting it in the context of a far-ranging change of the Thai political economy. But before doing that, it is appropriate to survey the orthodox financial policies with which the government has addressed its problems.

Defence of the currency expended forex reserves

Thai officials were convinced both that the currency basket peg could be defended and that it must be. They were conscious of the huge load of foreign debt that would become unbearable in the event of a large devaluation. Indeed, the Minister of Finance had previously headed one of Thailand's largest companies, which had some US\$4bn of foreign debt. Thus they gambled the country's entire foreign exchange reserves on defence of the basket peg, and when they failed the remaining net usable reserves amounted to only US\$1bn. This forced them into the arms of the IMF, which imposed high interest rates to defend the currency and fiscal austerity to reduce imports and thereby increase reserves. The result was a recession of extraordinary proportions — growth of negative 9.4% in 1998 — particularly extraordinary for an economy that had avoided all recessions since the late 1950s.

IMF austerity was excessive...

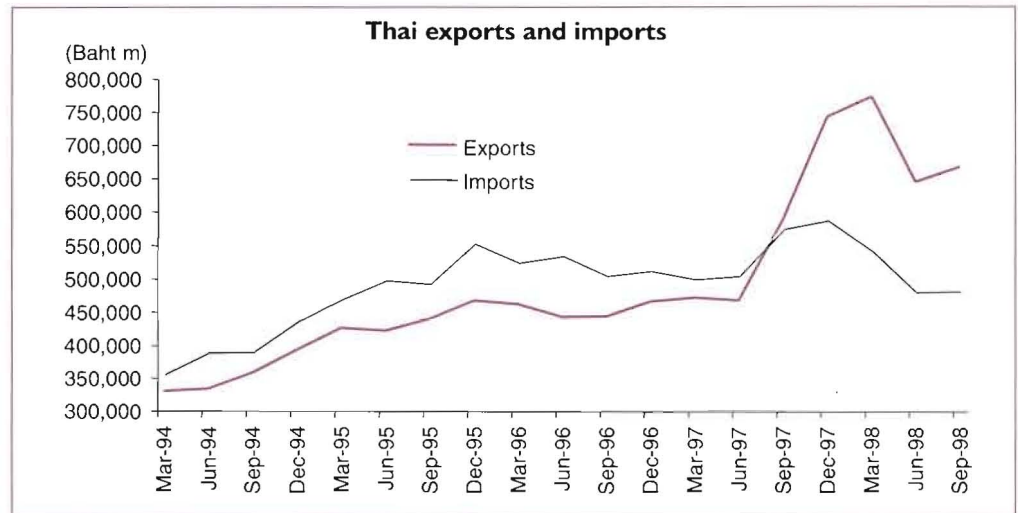
This result was not expected by the IMF, which had predicted positive growth despite the austerity programme. Even the IMF believed that Thailand was virtually recession-proof. In retrospect, the IMF insistence on a government budget surplus of 3% of GDP, together with extremely high interest rates, in an economy that had achieved fiscal surpluses every year in the previous decade, was quite inappropriate, and in fact the IMF later backed off, but only after the damage was severe.

...but lack of reserves precluded a balanced strategy

The generic response to a bubble popping should be to deflate the bubble sector and reorganise the banks, as the US did with its savings and loans crisis in the 1980s and as Japan failed to do in the 1990s, while simultaneously reflating non-bubble sectors of the economy. This is what China and, less vigorously on the reform side, Malaysia have sought to do with some interim success. Such a prescription is quite different from the usual IMF prescription that is designed to ameliorate Latin American or African crises brought on by chronic fiscal deficits. The Thai and South Korean ability to follow such a prescription was hampered, however, by the nearly complete exhaustion of their foreign exchange reserves. Even though the IMF demands for a budget surplus were excessive, rebuilding the reserves did require hitting the brakes. In the event, IMF excesses were spectacularly successful at collapsing imports and thereby creating a surplus that restored reserves.

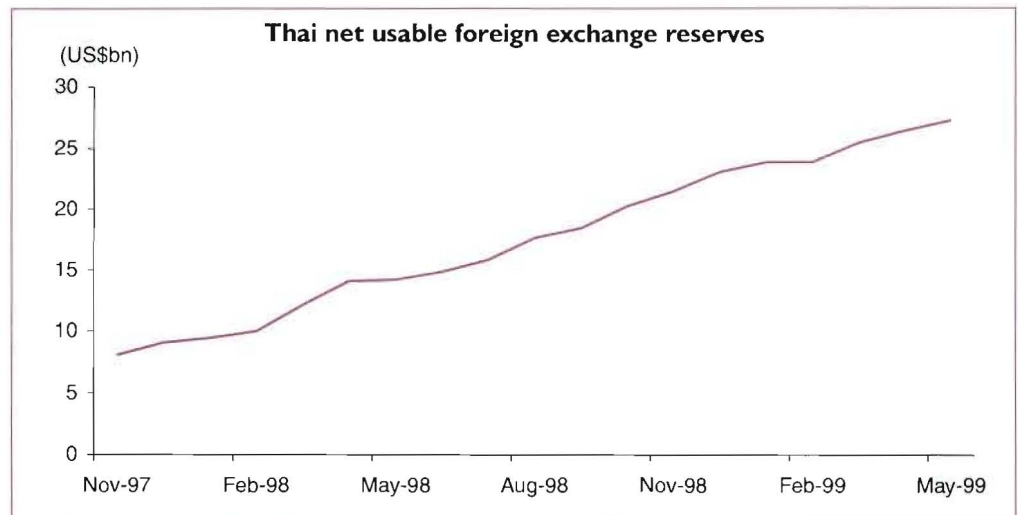
The IMF recession restored reserves

Import collapse...



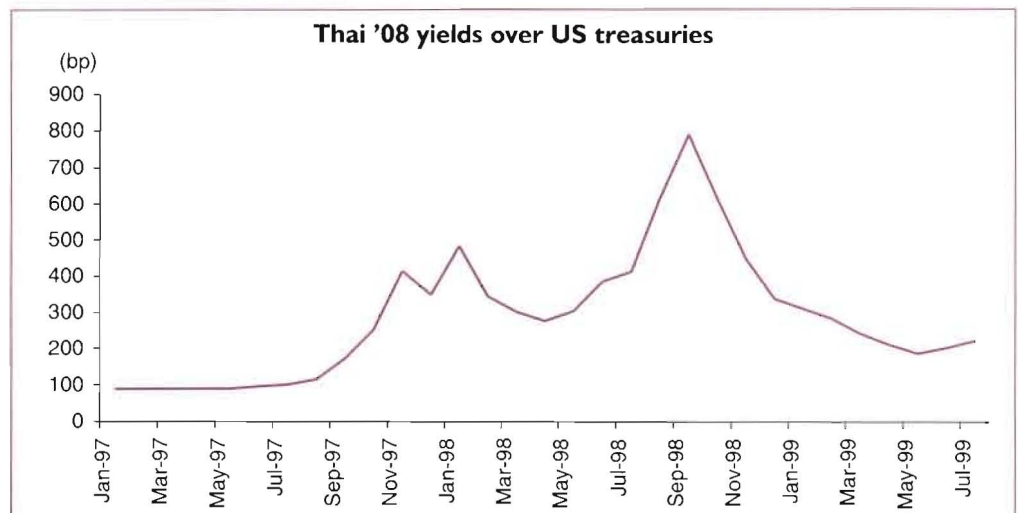
Source: CEIC

...rebuilt forex reserves



Source: CEIC

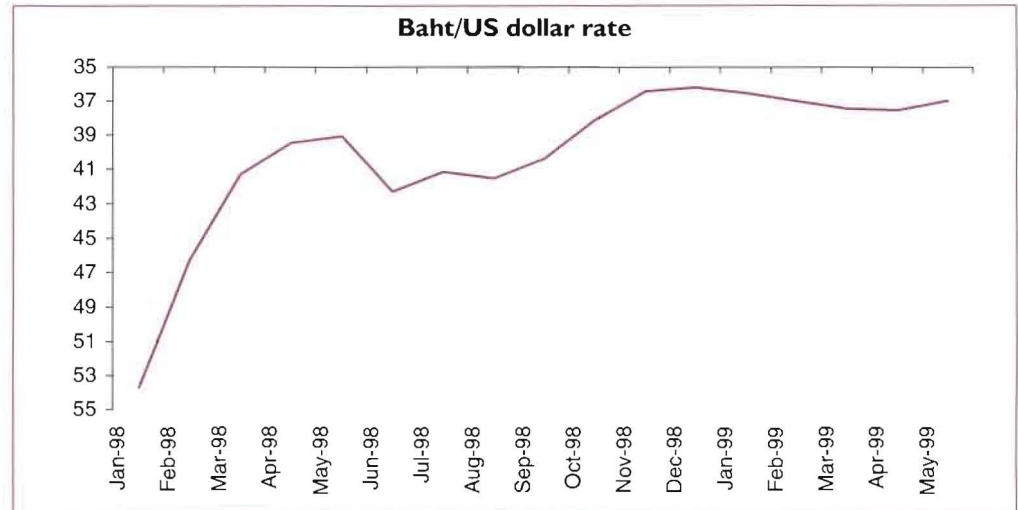
This in turn caused spreads on Thai sovereign bonds to tighten, yielding huge profits to those who followed the restoration of reserves closely.



Source: Nomura International (Hong Kong)

And it stabilised and strengthened the Thai baht, to the great benefit of the country's largest firms, most of which had huge foreign exchange debts.

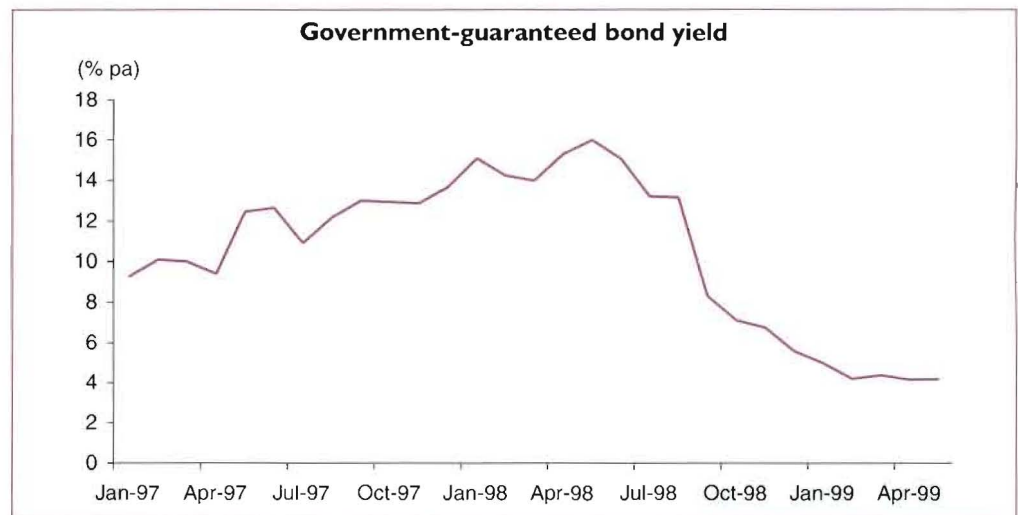
...which strengthened the currency...



Source: CEIC

...permitting interest rates to decline...

A firm currency, combined with recession and deflation, permitted a radical reduction in interest rates. The yield on a 1-year government-guaranteed bond fell from 16.02% in May 1998 to 4.19% in May 1999. The prime interest rate fell from 15.25% to 9.00% over the same period.

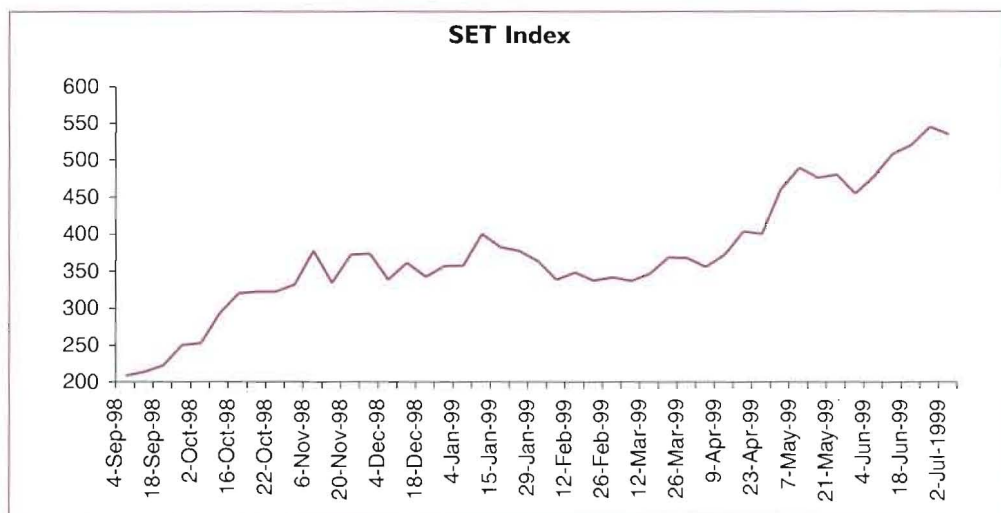


Source: CEIC

...and stimulating a bull market

The resulting flood of liquidity could not go to loans for corporations, because there were almost no creditworthy corporations left after the bust. Therefore it sat in the banks and flooded into the stock market. At the same time, international fund managers became disillusioned with Latin America and Europe and enamoured of the prospects for Asian recovery. Therefore, even though Thai companies showed minimal prospects for corporate earnings, the stock market soared⁶.

⁶ Extensive interviews with Thai bankers belie press reports of banks unwilling to lend. They are eager, even desperate to lend, and the few creditworthy firms are besieged by half a dozen banks wanting to lend to them, but most prospective customers are not paying on existing loans.



Source: CEIC

*But the real economy
still was not functioning*

All of this did a marvellous job of restoring financial markets, but left the job of restoring real economic functioning. The banks and finance companies were virtually all dying and needed either to be revived or put quickly to sleep. The majority of major companies were illiquid or insolvent. The credit system could not function now that banks were aware that the collateral and guarantees provided by their customers were virtually worthless.

Restoring the financial system

*Thailand immediately
closed half of its finance
companies...*

Faced with the collapse of its entire financial system as a result of the collapse of the property bubble and the inability of companies to repay foreign debt at the new exchange rate, Thailand acted decisively to close ailing finance companies but much less decisively to deal with more politically potent banks and major corporations. It almost immediately closed 58 failed finance companies, later reopening two. This was in itself an act of considerable political courage because many of these finance companies were partially owned or controlled by powerful politicians.

*...and quickly sold off
their assets*

Selling the assets of the finance companies was also implemented decisively. The Financial Restructuring Authority (FRA) was given the mandate to auction off THB866bn baht of assets and has been doing so quickly and honestly. Because of haste, there were some inefficiencies, eg, auctions being held without proper lists of the assets being made available ahead of time. But two independent reviews of the FRA gave it very high marks for performance within its charter.

*Not servicing assets
created "strategic NPLs"*

The problem with the FRA process was that the FRA was not given authority to service the assets — to manage the companies, to collect the debts, to restructure the debts, even to reorganise the companies — for a year and a half. The result was a major, apparently unnecessary increase in non-performing loans; borrowers who were not being pressed to pay made the decision to become "strategic non-performing loans." It became advantageous not to pay. Moreover, since the FRA had no authority to roll over loans that were paid in good faith, solvent companies faced a choice: pay and go bankrupt, or don't pay and keep the business alive. Such was the origin of the strategic non-performing loans that became about one-third of the NPL problem. Defenders of the decision argue that, in the Thai context, if the FRA had been granted the authority to service the assets, it would have been impossible to avoid a quagmire of corruption. That argument is uncomfortably powerful. On balance, the whole FRA process has been a major success. The FRA is now finishing its task. It will be terminated and its functions will be assumed by a new unit of the BoT and a new deposit insurance agency.

Recapitalising the banks

Only two banks have sought government funds

Only two banks have been willing to go to the government for capital and thereby dilute their ownership. In the government programme, the finance ministry matches funds raised from new or old shareholders by buying preferred shares in return for 10-year bonds — on condition that the bank must set aside full provisions for loan losses immediately. Siam Commercial Bank (SCBf.BK, THB51, BUY) raised THB65bn through this method. Thai Military Bank (TMBf.BK, THB22, SELL) is seeking THB15bn of government shares. Notably, the military has proved willing to accept dilution of armed forces shareholdings, another key step along the way to military professionalism. On the other hand, the government allowed that bank to count SLIPs and CAPs (see below) as matching capital, and agreed to buy shares at higher prices than existing shares are worth.

Much recapitalisation has just raised temporary prudential capital

Much of the bank recapitalisation to date has been the raising of prudential capital through special instruments called SLIPs and CAPs, whereby the banks create subsidiary mutual funds and can count ownership in the subsidiaries as Tier-1 capital. These instruments, which are widely regarded as a loophole in the Basle capital adequacy requirements, require payments of 12-22% annually, so the banks cannot become profitable until these instruments are retired. Only one bank, Siam Commercial Bank, has actually raised enough capital to cover its non-performing loans. For most of the banks, the raising of prudential capital just pushes the problem to a later date.

Current banking conditions are certainly helpful to banks' efforts at recapitalisation. The banks are taking deposits at 5% and lending at 10%. Some banks have developed a novel way of reducing their proportion of non-performing loans — by attacking the denominator rather than the numerator. They go to their best customers and offering loans at 4.5%, against the banks' cost of funds of 5%. This loses money but reassures regulators and helps to raise money from naïve investors.

New system may shrink 15 banks to six

The new banking system

Thailand's reforms will create a new banking system. There will ultimately be far fewer banks, perhaps as few as six rather than the original 15 (now 13). Foreign banks will play a much larger role, and the whole system will become more competitive. Bank of Asia (BOAf.BK, THB24, HOLD) has been taken over by ABN-Amro, Development Bank of Singapore (DBSM.SI, S\$17.70, BUY) has bought Thai Danu (DTDB.BK, THB18.5, SELL), and Standard Chartered Bank is trying to buy Nakhornthon Bank (NTB.BK, THB3.3, not covered). These foreign-dominated banks will bring much higher standards and much fiercer competition to Thai banking. Within the banks, practices really are changing. Top bankers almost universally recognise that they must change from lending on the basis of names and collateral to lending on the basis of balance sheets and cashflow. Already, competition from the foreign banks plus the painful lessons learned in 1997 is raising credit requirements and accounting standards.

Families shrinking banks to retain control

Families controlling banks are attempting to hang on to control even if that means severely shrinking the banks. In fact, Thai banking reform is noteworthy for the lack of official pressure to replace the managements and owners of failed institutions. For instance, the family controlling Bank of Ayudhya (BAYf.BK, THB22.5, SELL) has been determined to hold its position; it has successfully attracted new capital from a Taiwan investor and should thus be a survivor.

Bank managers have created problems, not solved them

First Bangkok City Bank (delisted) was merged into Krung Thai Bank (KTBf.BK, THB23, HOLD), which was already hobbled with an overload of bad assets. Laem Thong Bank was merged into Radanasin Bank, which may team up with Singapore's UOB (UOBMe.SI, S\$7, BUY). Both of these mergers basically destroyed the better bank rather than saving the worse bank. State-owned Krung Thai Bank has been hamstrung from restructuring by rules that prohibit state employees from being indemnified for causing a loss that results from a reasonable business decision. The regulations are likely to be modified by new restructuring guidelines, but this has created incentives

to delay transferring bad assets to special purpose vehicles, to delay realising losses, and to obfuscate accounting; it has greatly delayed reorganisation of Krung Thai Bank. The NPLs of Krung Thai Bank exceed 60% of its assets, and the spread it is earning is negative. Even worse, Bank Thai, created out of a dozen failed finance companies, a bank, and one solid finance company, has NPLs over 80% of assets and a negative spread. In our view, these banks should have been put to sleep but have been kept awake for political reasons.

*Two privatisations
delayed*

Siam City Bank (SCIB) and Bangkok Metropolitan Bank (BMB) were originally slated for privatisation by December 1998. This has been pushed back by nine to 12 months due to delays in recapitalising the banks and in government approval of loss-sharing arrangements with the banks' buyers. Interested investors are thought to include Citibank and HSBC (0005.HK, HK\$101, SELL).

Enhancing the credit and investment system

Bankruptcy and foreclosure

*Credit would no longer
flow under old laws*

Now that banks have discovered the weaknesses of their position under Thai law, the funds simply will not flow unless collateral and guarantees become more legally binding. The government managed to pass new bankruptcy and foreclosure laws which greatly improve the position of creditors although they retain important weaknesses. Thailand's earlier bankruptcy and foreclosure laws were written for a primitive agrarian society, where one of the great social risks was the potential for a horribly unequal society based on powerful landlords' oppression and foreclosure of weak neighbours. But laws targeted at avoiding oppression of poor peasants could not sustain the finances of an emergent industrial society. A creditor could force a debtor into bankruptcy, but the process of trying to seize assets or collateral typically took seven to 10 years and in the meantime the assets had a way of disappearing. Foreign banks simply would not return to a system where collateral and guarantees were worthless, and local banks' standards would never return to the old ones either.

*New bankruptcy court
looks good, new laws
better*

Thailand established a new bankruptcy court that opened June 18, headed by a judge who is respected as a rising star. Over fierce opposition, new bankruptcy laws were passed in May 1999; these require that personal guarantees, including past financial guarantees, be honoured⁷. The new bankruptcy laws change the process of trying to invoke guarantees and seize collateral from a seven- to 10-year battle to a three- to five-year fight. (Taiwan, which has one of Asia's better systems, typically requires three years.) It also changed the bankruptcy penalties to make bankruptcy more socially tolerable; instead of being banned for life from the civil service or from monkhood, a bankrupt individual is now banned for three years.

*But new bankruptcy
laws have weaknesses*

The bankruptcy law and system continue to have critical weaknesses. There is no Thai equivalent of US Chapter 11 bankruptcy (protection during reorganisation) for individuals or partnerships. It only allows bankruptcy based on a balance sheet test, and with Thai accounting most businesses can show a balance sheet with more assets than liabilities. The proper test would be one of ability to generate adequate cash flow adequate to repay debts. But leading lawyers argue that well-designed presentation of a case can usually overcome this defect. There is no regime for secured lending other than property and personal guarantees; cashflow and movable assets cannot be effectively used as collateral. Judges have no experience with cases involving more than one creditor, and the police have negligible capability to probe fraud and other complex financial problems; in addition, a white-collar criminal can usually buy his way out of a problem.

⁷ Nonetheless, those who issued personal guarantees are still finding ways to walk away from large parts of their obligations. It is not unusual for large guarantors to insist that the banks write down their obligations by 40% or more under the threat that otherwise the guarantor will refuse to pay for 90 days and the bank will have to write down the whole asset — a big potential problem for banks with potentially lethal non-performing loans facing huge debtors.

*Foreclosure laws better
but weak*

Foreclosure is quicker now, though never automatic. A debtor whose assets are foreclosed still remains obliged to pay the debt, so debtors always fight against foreclosure.

*No big drive to improve
transparency laws...*

Transparency

Another requirement to create a sound financial system is that company accounts and reports to investors must be reasonably complete and accurate. By tradition, Thai companies have kept one set of books for the tax collector and one for themselves; this habit easily evolved into keeping one set of books for banks and minority investors and one for themselves (and possibly a third for the tax collector). In South Korea, a similar problem has been dealt with by the president's demanding and imposing more international accounting standards and more consolidated accounts. In Thailand, there has been no such drive. The government has agreed with the IMF to amend the civil code to improve transparency, but this is seen as very complicated and nobody seems to be giving it very high priority. Thai lawyers argue that Thai regulations are not the problem; the regulations, they say, are there but have never been enforced.

*...but old laws better
enforced*

What appears to be happening in Thailand is that the standard of practice is being raised, not through any impressive decrees but by insistence of the banks, by accountants' new awareness of the possibility of being sued, and by new awareness on the part of the government and the courts that this formerly abstract concept of transparency can be of life or death importance. The international accounting firms are taking control of their local partners and telling them to shape up. When Siam Commercial Bank was raising new capital, its extensive disclosure was unique in Thai financial history. That new positive benchmark, and the success that it brought, will influence future deals.

*Political change
enhances transparency*

The financial principle of transparency is also creeping in through the back door of politics under the name of freedom of information. The new law on freedom of information has led to a wide opening of previously closed doors. There is currently, for instance, something of a fad for parents of children rejected by schools at all levels to exercise their freedom of information rights and get the exam scores of their own children to compare with those of more successful children. What they find has been making headlines and embarrassing even one of the country's most prestigious universities. It will be virtually impossible to curtail the trend toward greater openness. Such an indirect and gradual change of standards is very Thai and very fuzzy to analyse. But the change is also quite real. Nobody at Bangkok Bank thinks it's a good idea any more to make a loan based on a casual conversation with a potential borrower, a check of his relatives, and an impression of his thumbprint. In practice, the change in South Korea will be gradual, too, and the market-driven changes in Thailand may have more staying power and more resistance to political counter-pressures than vivid South Korean decrees.

Fraud is serious....

Closely related to the problem of transparency is the need to overcome an extraordinarily prevalent practice of fraud in valuing collateral. In a typical case provided by a consultant, a woman bought a house for THB20m, then went to a finance company and asked for a loan of THB50m using the house as collateral. The finance company officer said the house wasn't worth so much, but offered to provide the THB50m if she would pay him THB5m. She did so, then made no payments on the loan for seven years. The crisis came, the finance company was closed, and the loan ended up in the portfolio of one of Thailand's biggest banks. The bank called her and offered to clear her title for THB10m, which she provided, after complaining falsely that it was hard for her because times were tough. A senior banker said that such cases were quite common and that the woman must be unusually honest because most people wouldn't have paid anything. The two biggest causes of loan difficulties, according to interviews, are bubble prices on collateral and fraudulent prices on collateral, with bubble prices being about 75% of the problem and fraud being an extraordinary 25%. The system is being changed, and valuations are supposed to be done by trained auditors. Some banks are moving to have loan decisions made by committees rather than individuals as a brake on corruption.

*...valuation system is
improving*

Formal restrictions on foreign ownership being loosened

Alien Business law

Thailand has had complex and theoretically severe restrictions on foreigners' ability to own companies in Thailand. Among other things, the law greatly restricted the ability of foreigners legally to own property and to own controlling interests in banks and finance companies. Much of this law was unenforced. For instance, senior officials were usually willing to work out ways for foreigners to own far larger shares of finance companies than the law technically permits. The practice of law is Category A, closed to foreigners, but in practice Thailand is much more open to foreign lawyers than Singapore or Hong Kong, whose laws are less restrictive. But the laws were great deterrents to foreigners' ability and willingness to buy distressed property assets, to foreclose on property, and to invest in banks and finance companies during the crisis. Under a proposed new Alien Business law, such restrictions would be greatly loosened, and in the meantime the Ministry of Finance is granting exemptions to the continuing legal restrictions on foreign investment in financial institutions.

The financial reorganisation process requires numerous other legal changes. For instance, government banks have generally been unable to give haircuts, because an old law against wasting public money makes directors of those banks personally liable for wasting public funds if they agree to a haircut, however necessary. Such problems have slowed the reorganisation process considerably.

No improvements in corporate governance

Corporate governance

Unlike South Korea, Thailand is taking no steps that will greatly improve corporate governance. As one top consultant said, "Minority shareholders in Thailand are suckers."

Restructuring insolvent firms

Corporate restructuring slow

Progress on restructuring has been painfully slow. As of May, 1999, the BoT had identified 68,983 companies that had gone through debt restructuring (52,681, with THB430bn outstanding) or were in process (16,302, with THB825bn outstanding)⁸. As these numbers suggest, Thailand's problem is much more complex than Korea's. In South Korea, the majority of the debts are held by only a half dozen conglomerates. In Thailand, even the top 600 debtors do not hold half of the non-performing loans.

Initially, no progress

Initially, there was no incentive for companies to come to the table. Banks could not foreclose on corporate assets and could not effectively invoke guarantees that had been given. Forcing a company into bankruptcy gained the banks only spite, not assets. As noted in the discussion of the FRA, there were even incentives for firms that could pay their bills to stop paying them. The new foreclosure and bankruptcy laws gave the banks tools to force companies to negotiate. But neither side liked the idea of referring disputes to the courts. At first, creditors and debtors simply failed to meet. So the government has designed a system to bypass the court process.

Now, BoT process forces action on financial firms...

For financial firm debtors, there is a BoT process, currently in use for about 300 companies. The creditor submits a plan to the BoT, and then a negotiation process ensues according to rigid BoT deadlines. The BoT is authorised to impose penalties on any debtor that doesn't comply.

⁸ For further details, see the table in Anoma Srisukkasem, "230 debtors face legal action," *The Nation*, Section B, July 3, 1999, p. 1

*...and CDRAC process
drives big corporates*

For non-financial firms, the big creditors have agreed that 75 of creditors can impose an agreement and that 50 can push a company into mediation. The government formed a committee, the Corporate Debt Restructuring Advisory Committee (CDRAC), funded by the World Bank, which creates a mediation process for the big companies. Unlike the Indonesian process, Thailand's treats each company individually — 36 steps each for 667 companies. Once companies agree to enter the process, they and the banks must meet deadlines for each step, under the guidance of a mediator. By the first week of July, 1999, 57 of these 667 companies had actually been taken to court for failure to meet their deadlines and a total of 230 faced legal action for failure to meet their 1 June deadline.

*For single cases, CDRAC
works*

It is still early days for the CDRAC process, but there are some preliminary reactions. One consultant took a client through the process. It was a simple situation of one client who couldn't pay one creditor, but there were some peculiarities in the client's position, as there usually are in Thailand, and the bank was known for being exceptionally intransigent. A foreign judge with conspicuous competence and lack of vested interests led them through their presentations. The numbers made it clear that the bank's intransigent position would lead to its getting virtually nothing; after minimal discussion the two sides reached a satisfactory compromise.

*For complex ones,
verdict not yet in*

More complex companies complain about the process. They are not permitted to pledge assets during the process, potentially interfering even with making necessary deposits to the electric company. They are not allowed to transfer assets among member companies, potentially causing difficulties if, for instance, a chain of stores with complex ownership structures needs to transfer funds and other assets in order to maintain uniform standards and products throughout the chain. That leaves the group vulnerable to the personal whims of the regulators and could become an opportunity for regulators to demand bribes. On the other hand, the ban on transfer of assets is an obvious bar to the traditional Thai practice of bleeding all the assets away in a bankruptcy. It remains to be seen whether the system balances such concerns successfully, for instance by allowing a representative of the creditors to approve asset transfers and pledges. Such details are life and death issues for the restructuring companies.

The bankruptcy process itself has had mixed results. Srithai Superware, generally regarded as a high-quality small company (and hence a relatively easy case), required two years of discussions with creditors before coming up with a reorganisation plan to submit to the bankruptcy court. (Submission to the court is necessary because otherwise key benefits are lost; for instance, if the bank takes a haircut, the debtor must pay a 30% tax on the haircut and the creditor cannot deduct it as a business expense.)

The innumerable smaller troubled companies are given a month of free consulting subsidised by the government in an effort to sort out their problems.

*"Restructuring" is
mostly just rescheduling,
which defers the
problem*

Much of the "restructuring" that has been done is really just rescheduling, with overdue interest being capitalised, loan duration stretched out, and interest rates reduced to levels that can be sustained by the cashflows of the borrowers. For companies facing temporary or cyclical problems, such rescheduling, together with the low interest rates prevalent today, should provide a permanent solution. In fact, about half the overdue debt comprises short-term loans (less than one year) that in many cases can be rescheduled without damage to either party. This is where the most progress has been made. But most market observers believe that the majority of troubled loans involve deeper problems, and the lack of more fundamental restructuring (banks taking haircuts, companies selling subsidiaries or bringing in strategic partners, major employee layoffs...) just postpones the problem a year or so. Most companies are not paying and not restructuring either, but the process of resolution/postponement is gaining momentum. According to the BoT, at the end of April THB384bn of debts had been rescheduled. The trend in numbers is auspicious, but the first substantial downturn in growth or uptrend in interest rates may bring a need to re-restructure many of these.

Government policy has implicitly encouraged such a process of rescheduling rather than restructuring. The regulations require banks to provision for 20% of their non-performing loans every six months, beginning with 20% in December 1998, so full provisioning is not required until the end of the year 2000. A bank that does a real restructuring would have to provision for 40% of the loan by June 1999, but if it reschedules for window-dressing it only needs to provision for 16%.

On balance, the process of corporate restructuring is disposing of large numbers of easy cases (short-term loans, strategic NPLs) and seriously restructuring a few high-profile firms (Siam Cement (SCCf.BK, THB1,204, SELL), CP Pokphand (CPf.BK, THB67.5, not covered), and others) but is also just deferring many cases to a round of more serious restructuring that will have to occur a year or so later.

Banks' retribution will come later

Part of the second round will be banks' coming to terms with company management teams that have proved irresponsible. One of the noteworthy features of both the financial and corporate sector restructurings in Thailand is that the managements of insolvent banks and companies have largely been left in place. For the banks, this appears likely to endure; many of the leading bankers have too many friends in high places. For the time being, the banks are also leaving the corporate managements of their restructuring customers in place, because under Thai law it is just too difficult to get rid of them. But bankers say there will be a credit bureau and a blacklist, so many of those who became "strategic non-performing loans" at the banks' expense will eventually pay a price. The process will be slow and the outcome personalised and erratic, but if Thai society runs true to form, the majority of what needs to be done will get done.

Overall: right direction, incomplete

The overall process of financial restructuring, corporate restructuring, and legal reform consistently moves in the right direction and shows no signs of backsliding, but consistently stops short of doing the job completely. This is characteristic of Third World reform programmes and should not lead to excessive disillusionment. The region's most developed stock market, Hong Kong, has had roughly one crisis each decade since the 1960s and each time has undertaken a major upgrading of standards, reaching the bottom tier of First World standards in reforms after the crash of 1987. Thailand and Korea are following a couple crashes behind Hong Kong and Singapore, while China and Indonesia lag Thailand by a couple of steps⁹. Even in the US, stretching out the write-offs was the key to resolving both the 1970s and the 1980s crises of the big money centre banks, and the restructuring of the "rustbelt" of the American mid-West stretched out over more than a decade.

Foreign presence will enhance reform

In this whole process, foreigners play an increasingly vital role. Thailand has a major advantage here, because though Thai nationalism is very strong the integration of Thai and foreign companies is not particularly difficult. As one banker put it, "We don't have Korean xenophobia here, and we don't have Korean unions." Except, he might have added, among the state enterprises, where privatisation is so far going nowhere.

9 Thailand's 1984 crunch and devaluation precipitated the shift from import-substitution policies to export-led growth.

Are the reforms politically sustainable?

Opposition drags feet, doesn't seek reversal

The central lines of policy conflict during the economic crisis have been between the reformers and the foot-draggers. Nobody is trying to reverse existing reforms, just to drag feet on implementation of old reforms and legislation of new ones. For instance, the Senate delayed and modified the new bankruptcy and foreclosure laws in apparent efforts to protect the interests of some of that body's wealthier debtors and their friends.

Privatisation intensely opposed

Currently, privatisation is the most hotly disputed battlefield. Unions and management alike have hotly opposed privatisation of Bangchak Petroleum (BCPf.BK, THB20, SELL, EGAT (Electricity Generating Authority of Thailand), Thai Airways, the Telephone Organisation of Thailand, and Krung Thai Bank. The rallying cries of opposition have been the same as everywhere in the world, from contemporary China to Margaret Thatcher's Britain: the loss of jobs is inhumane, and selling any part of, for instance, Bangchak Petroleum to foreigners would desecrate the national patrimony. Such views have enough money and political trouble behind them that progress in most areas has been grudging and just enough to avoid further catastrophic financial collapses. A series of privatisation bills later this year faces difficult opposition. They must pass the Senate, and many senators have both strong personal interests in opposing privatisation and certain knowledge that they will not have places in the new Senate elected early in the year 2000. Thus the prospects for privatisation are limited and slow.

Government strategy: coping, not vision

The Chuan government's policy approach has been to do what is necessary to cope with the financial crisis rather than pursue a broad vision of a reformed Thailand. Even within the context of the immediate crisis, the Chuan government has focused public attention on financial sector reforms and has been reluctant to lead the public toward recognition of the broader problem of overcapacity and the associated need for bankruptcies and layoffs. Such an approach contrasts sharply with Kim Dae Jung's Korea, where the president eloquently advocates and relentlessly pursues a vision of a much more open, transparent, competitive, efficient economy that he also expects to enhance the country's democracy. Moreover, Chuan has delegated the economic reform drive to Finance Minister Tarrin Nimmanhaeminda, who takes the heat for painful reform policies. Chuan's instinct would appear to be to play it safe.

Thai leadership is circumscribed

More importantly, any Thai prime minister faces severe constraints in how far and how fast he can lead. The role of the King prevents anyone else from being the ultimate moral and political arbiter, and the politics of running a coalition based on a minority party hampers any strong leadership. The fact that the parties and coalitions have no strong base of ideology or principle other than the self-interest of the members deprives the leader of any firm policy platform. Chuan provides the government with an image of relative integrity, and he maintains the organisation of a more cohesive party than Thailand has ever seen. Tarrin provides the substance of reform. As indicated below, the issue of integrity is a central one, in many ways a stronger driver of the country than the economic reform.

Public understanding remains limited

The lack of forceful articulation by the prime minister of the causes of the problem and a vision of Thailand's future has less tangible but nonetheless important consequences for public opinion. There is a widespread view of the crisis as an aberration, or as bad luck, or as having been caused primarily by nasty foreign speculators abetted by some bad decisions at the BoT. (The one excuse that doesn't work in Thailand is contagion, since the illness started there.) This leaves an unquantifiable but substantial part of the population believing that, if they just hold on, life will go back to the way it always was. It won't.

*A different government
would slow reform*

While an opposition government would probably not reverse the principal reforms, it might well gut or delay both political and economic reforms. This writer believes that at best a new government under Thaksin would move forward but only after a lengthy period of putting its own stamp on programmes and making changes to satisfy a new set of interest groups. At worst, a government under Chavalit would adamantly oppose privatisation and drag its feet on implementation of many existing reforms. Thus the staying power of the current coalition is economically significant. Fortunately for the government and the reform, most of the opposition is in such bad repute with the electorate that there is little chance of the opposition's experiencing a sudden surge of popularity or credibility with the electorate. And General Chavalit, head of the New Aspiration Party, who probably has the biggest warchest, still attracts skepticism from potential coalition partners because he chose so many outsiders as ministers when he was prime minister.

*The government
opposes an early
election*

The government believes it will and must endure until late in the year 2000 — with the following rationale. Currently, the government has a comfortable majority of 236 seats to the opposition's 149. During the current session of parliament, June to October 1999, there is a prohibition on motions of no-confidence. Then the country will be reoccupied with preparations for the King's 72nd birthday in December and nobody will want an election until it is over. Between January and March 2000, the country will elect the first Senate under the rules of the new constitution which require for the first time that every senator be elected rather than appointed¹⁰. In June 2000, there will be Bangkok city elections, and Bangkok is a critical power base for the national elections. The government feels it must hold on through then, and it believes that by mid- to late-2000 the economic recovery will be much more advanced and the voters more grunted.

*The risk is not from the
opposition, but within
the coalition*

Thus the government is determined to hold on, and the electorate doesn't like the opposition. But one cannot conclude too firmly from this that the government is stable. As that great cartoon strategist, Pogo, said, "We have met the enemy and he is us." All three major coalition partners of the Democrats have been engaged in fierce internal struggles over who should become ministers. In none of these struggles do policy issues play a significant role, and in none of the parties concerned is there much concern for continuity of policy. The problem is that the implementation of the new constitution next year has set off a feeding frenzy to get ministries before the feeding trough is changed. Under the new constitution the number of cabinet seats will fall from 49 to 35. Moreover, many current political leaders will be ineligible or unlikely to obtain ministries under the new constitution, which requires among other things that ministers must have a bachelor's degree and must not be elected officials. It will no longer be easy to obtain a ministry by bribing a party elder, and a prime minister will no longer be so able to justify inappropriate appointments by referring to coalition politics. The desperation of legislators, and the utter lack of principle with which they pursue their last shot at the prestige of being minister, and in many cases the last good shot at the wealth that comes from having a hand on the public spigot, has led to self-destructive conflict that can only be compared with sharks that have found blood in the water but no meat and have taken to biting each other.

*SAP has left the
coalition*

The worst of these conflicts has occurred within the Social Action Party (SAP), a member of the coalition with 20 seats, four ministries and five factions. A majority of the party legislators, who do not have ministries, attacked the leadership of the party demanding a turn at the trough, resulting in the resignation of the party leader and the departure of SAP from the coalition. This nonetheless left the government with a comfortable majority of 236 seats to the opposition's 149, but also with the uncomfortable task of newly parcelling out the ministries among the remaining divided and belligerent members of the coalition.

¹⁰ Traditionally the Senate has been a check on the frequently over-populist lower house, but also a bastion of military political power and plutocratic reaction. The new Senate tries to retain some of the old resistance to populist demagoguery while banishing the worst elitist abuses by requiring the election of every senator but banning all candidates from joining political parties or conducting political campaigns.

*Other parties fear
Democrats' strength*

The governing coalition even manages to derive weaknesses from its strengths. Under Prime Minister Chuan, the Democrat Party has become Thailand's first cohesive party and a potent policy instrument. Because of this, the longer the Democrats stay in power, the more they overshadow their fractious, policy-indifferent coalition partners. This creates an unspoken concern among some of the partners that the Democrats need to be unseated before they become too strong. On the other hand, elections are very expensive and the party opposition have huge war chests, some of which were allegedly built up from foreknowledge of the devaluation.

Meanwhile, the string of small scandals — in rural elections, in the health ministry, and elsewhere — that seems all but inevitable in any Thai government gradually saps the prestige of the governing coalition. The unprincipled feeding frenzy over ministries during the July 1999 cabinet reshuffle may trigger substantial public disgust. While the prime minister continues to enjoy a reputation as the most honest politician in Thailand, a nearly equal proportion of the electorate, about one-third, expresses admiration for the government's handling of the crisis and disgust at its corruption.

*No risk of social
disruption*

Thailand faces no risk of serious social disruption as a result of the crisis — assuming there is no big surprise that makes it much worse. Unlike in South Korea, most Thai unions are weak and docile. Unlike in China, unemployment is not so severe as to create fear of widespread unrest; the rural areas have absorbed many of those who lost their jobs in Thailand. Unlike in Indonesia, the experience of the average Thai has been a setback of several years in income growth rather than any real risk to basic livelihood. The poor were mostly not hit hard. The main hit was to wealthy people with large property assets, large stock market positions, or large loans denominated in foreign exchange. Such people will take retribution on the government that was in charge at the time of the crisis but should not be a source of social unrest.

*The risks favour the
government*

The chances are good that the coalition will indeed hang on, but the risk of self-destruction must be closely monitored. In an early election, the fact that the opposition is disliked provides no guarantee that it will not come to power as a result of complex multi-party negotiations. An early election might well cause a sharp decline in the stock market.

Foreign policy

*Exceptionally good
foreign relations
facilitate recovery*

Foreign affairs has been an asset for the Kingdom's economic adjustment. Thailand, the only Asian country sufficiently agile to balance the big powers and avoid colonisation or dismemberment in the late 19th and early 20th centuries, has continued to demonstrate its international agility. It has remained on good terms with its Asean neighbours, and is on better terms with China and the US than ever in modern history. Notably, Li Peng visited Thailand and Jiang Zemin is preparing a visit; no other developing country receives this kind of attention. Under the current government it has greatly improved relations with the neighbouring states of Indochina after having modified the rapacious policies of the Chatichai and Chavalit eras. (The Chatichai slogan of "Turning the battlefield into the marketplace" was a clever cover for a policy of ruthless exploitation.) This balance has enabled the government to cut back on military expenditures and to concentrate foreign policy on efforts to get help with the financial crisis

A footnote to this is that the country has two grievances in current relations with the US. The US did not participate in the original Thai rescue programme because of crippling US Congressional amendments after the Mexican bailout. Those amendments expired prior to the Indonesian crisis, so the US ended up helping Indonesia, which has never been so close to the US, and failing to help Thailand, a formal ally since the 1950s and always a close friend.

*Quarrels with the US
are limited*

Then the two countries got into a spat over the nomination of Deputy Prime Minister Supachai Pantitchapakdi to head the World Trade Organization (WTO). For Thailand's governing Democrat Party, this nomination was the solution to a potentially fatal problem, namely the rivalry between Dr Supachai and Finance Minister Tarrin Nimmanhaeminda. Both are distinguished economic leaders; both are top Democrat Party leaders. They had a conflict over economic policy, and Tarrin won. Having them both in the cabinet, and both as party leaders, risks a damaging internal conflict, so getting a prestigious international position for Supachai has become the key to Democrat Party cohesion. The US fears that Supachai would lack decisiveness on tough issues and would prove soft on intellectual property issues such as pharmaceutical patents. The US view may be shortsighted, since having a distinguished Thai running the WTO would demonstrate that WTO is not just a rich man's club. In the longer run of Thai development, these two problems appear relatively insignificant.

Economic recovery

Attempting to stimulate a recovery...

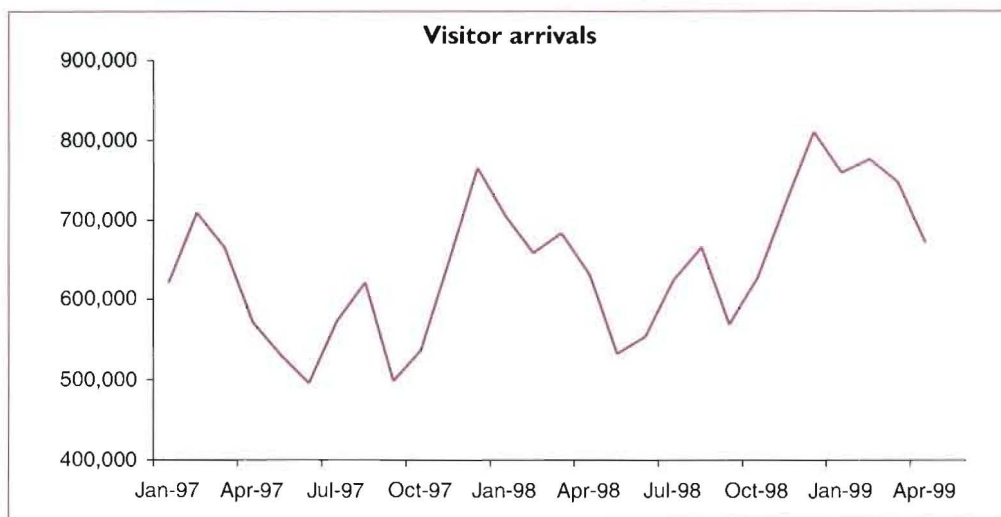
In addition to imposing painful reforms, the government has attempted to stimulate a recovery. It reduced the value-added tax from 10% to 7%. It has encouraged the vast decline of interest rates (see chart, page 29). It has set a stimulative budget deficit of 6% of GDP, and it is spending Miyazawa funds from Japan, amounting to 2.5% of GDP, to create as many as half a million new jobs.

... albeit not very efficiently

None of this has been done efficiently. As of the end of June, it looked probable that the government would manage to spend only THB650bn of its planned THB800bn budget. The Miyazawa money is being scattered to the village chiefs — THB1m to each village administrator — and used to revive the property sector without any effort at economically efficient use, notwithstanding that eventually this money must be repaid.

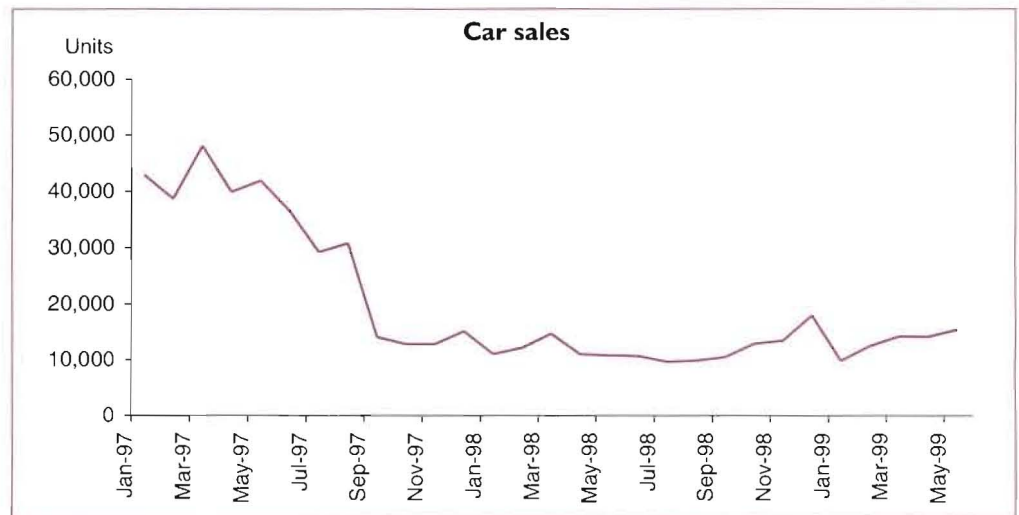
Signs of revival in confidence

By mid-1999 improved confidence was palpable in Bangkok. First-quarter growth was 0.9% and 2Q99 numbers seemed likely to be much better¹¹. Interest rates were at a modern low, and the economy was awash with liquidity. Capacity utilisation (52.1% for 1998, 56.9% for April 1999) and manufacturing production were starting to rise. Real purchasing power was rising, and businesses were beginning to re-stock some inventories. Monthly vehicle sales were up 50% from their low. Sales of white goods, consumer durables, and department store items were rising. Agriculture is recovering from an earlier drought and may recover further if low commodity prices (rubber, rice, sugar, tapioca, shrimp, chicken) begin to recover. Low-level housing was recovering (but there was still a huge overhang of commercial property — a segment in which transactions simply have not been occurring, an indication that the market is not clearing). Corporate tax collections were 50% over budget.

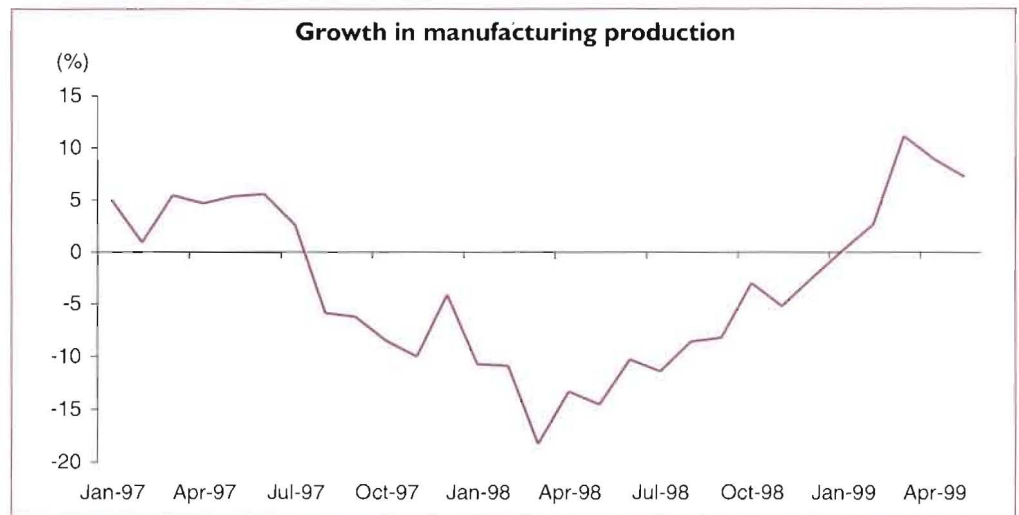


Source: CEIC

¹¹ Thai statistics leave much to be desired. Different government departments frequently provide conflicting numbers. The market relied on 1Q99 GDP growth estimates from the National Economic and Social Development Board of minus 4.7% until June 30, when BoT reported that the correct number was plus 0.9% — an overnight swing of 5.6%.



Source: CEIC

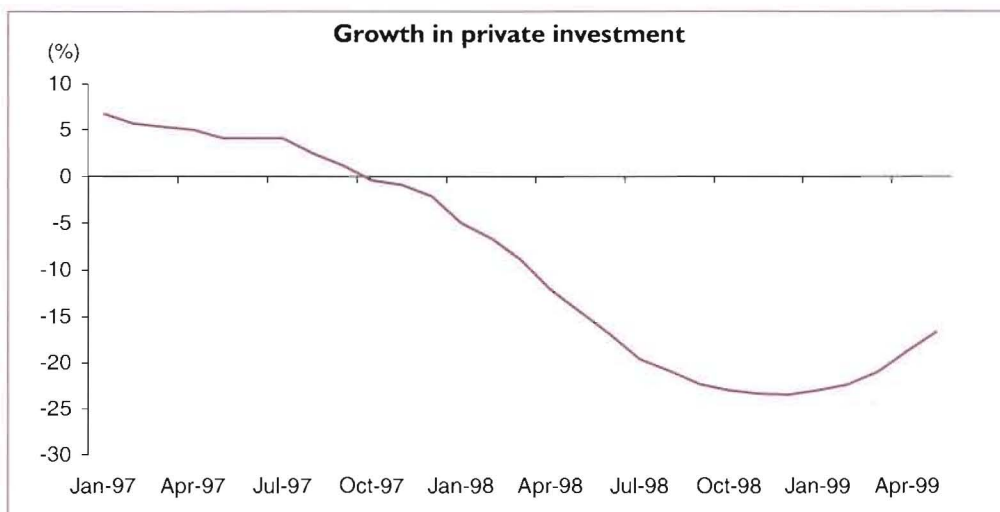


Source: CEIC

Exports and tourist numbers are up

According to the BoT's preliminary numbers, after being stagnant in 1Q99, April exports rose 4.7% and May 1999 exports rose 6.5% over the previous year; the BoT says June exports probably rose by more than that. The bright spots are cars and electronics. Thailand expects to export 150,000 cars in 1999, and Japanese companies are telling their subsidiaries to stock up prior to the year 2000. Electronics exports are growing at a 30% annual rate. Foreign direct investment has been rising and is now expected to be US\$5-7bn for the year. Tourist arrivals for comparable months are increasing over last year.

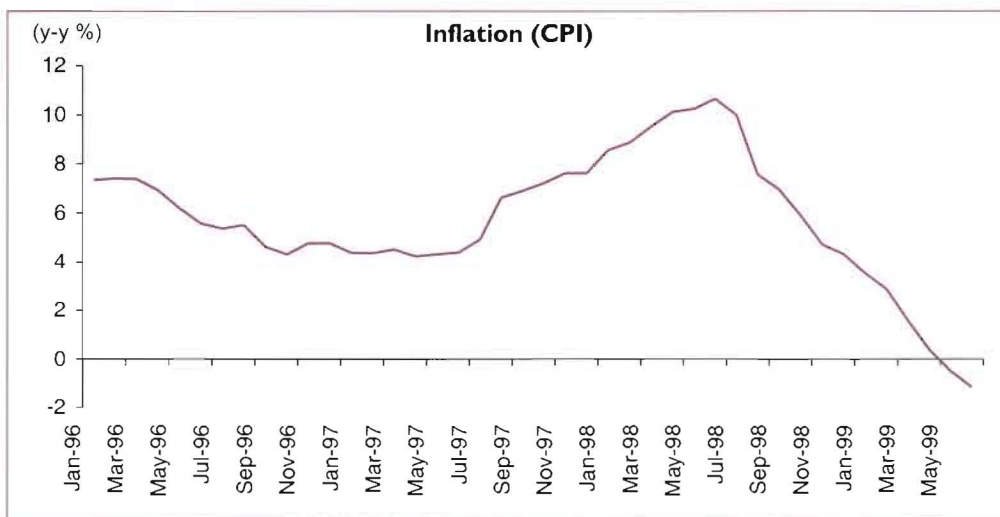
However, bank lending and private investment have remained stagnant.



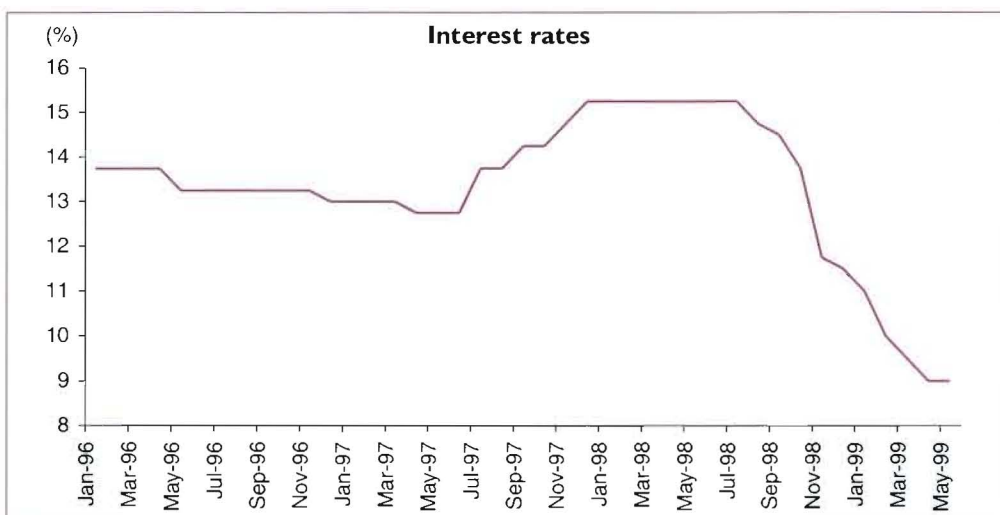
Source: CEIC

*Room for additional
interest rate cuts*

Inflation has been held down by overcapacity and by a strong exchange rate. The cut in the value added tax from 10% to 7% has kicked the CPI numbers into negative territory, but Thailand does not seem to be headed into any vicious deflation cycle. The disappearance of inflation, plus the strong current account and the stable currency, provide some additional room for interest rate cuts. That, plus ample liquidity and positive sentiment, provides support for a strong stock market for at least a few months.



Source: CEIC



Source: CEIC

Longer-term economic prospects

Old manufacturing industries obsolescent

The labour-intensive industries that have long propelled Thailand's growth are now obsolescent. Textiles, footwear and toys are failing to recover due to competition from China and others. While a depressed exchange rate reinvigorates some of these for a while, this path to growth only offers Thailand the opportunity of recovery without development.

Electronics faltering, heavy industry a big loser

Thailand's effort to follow other Asian countries up-market into electronics have largely failed. Although production and exports under this general category are substantial, Thailand's electronics industry is basically just assembly and packaging. There is no significant R&D. The country has made an even bigger effort, dating back slightly more than a quarter century, to build steel, refining, and petrochemical industries. These have survived only by virtue of high tariffs and other subsidies and have been a drag on the national economy since they began, monuments to a generation of Thai planners who were convinced that the only proper future for Thailand was to follow South Korea into these industries. During the era when capital seemed unlimited and when Thailand's growth and export prospects seemed unbounded, these investments seemed to be an affordable luxury. Now they are soaking up desperately scarce capital and raising the costs of downstream industries, potentially making Thailand less competitive in cars, white goods, machinery and precisely that range of products that offers hope of a return to vigorous development and income growth.

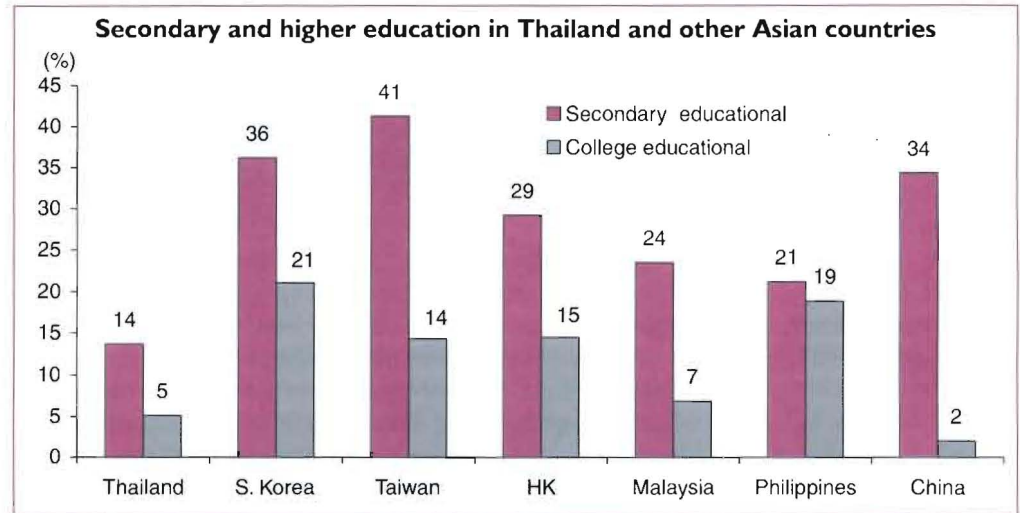
These counterproductive investments need to be deprived of subsidies and extraordinary tariff protection, then written down and sold off at market price to end the drag on the larger economy. But of course such decisions face strong opposition from unions, management, and nationalists who do not understand the damage that is occurring to Thailand's longer-term prospects.

Educational failure...

Thailand's difficulties in moving up-market derive heavily from weaknesses of infrastructure & education. Of these, despite the terrible Bangkok traffic jams, the more serious shortfall is in basic education. The education provided to Thailand's people is dramatically less than in Thailand's Asian competitors. Moreover, basic education is based on obsolete textbooks. It is an inexplicable contradiction in development strategy that precisely those planners of the 1970s and 1980s who insisted on emulating South Korea's industrial strategy failed to take account of the foundation of all South Korean development: universal, high-quality education. This failure derives first of all from the elitism of Thai society, as compared with the egalitarianism of South Korean society. The top universities are not bad, though senior people at the Ministry of Universities try to send their children abroad, but tertiary education is much more highly developed than secondary education. The primary education which is provided in the rural areas is vastly inferior to its urban counterpart. In other words, at each lower rung on the social scale, the quality becomes far worse.

Secondarily, it is affected by the incentive structure of Thai politics: traditionally, the job of Minister of Education has been considered second-rate because it is more difficult to make money than at Commerce or Telecommunications, whereas in Korea education has great prestige and in Malaysia the education ministry is a stepping stone to the top. While the current government should be congratulated for trying to raise the education budget substantially at a time of stringency, the Ministry of Education is still being used as one of the most prominent political footballs. As this is written, the conflict over deputy ministerships in education is a highlight of nearly every daily newspaper, and neither education policy nor the quality of the aspirants is ever mentioned as a consideration.

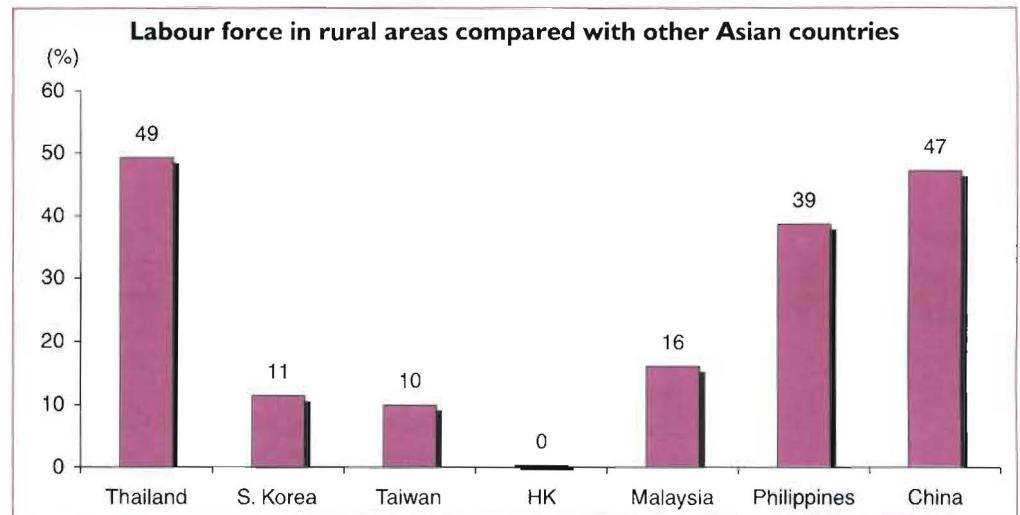
Thailand spends about as high a proportion of its GDP on education as other Asian countries, but wastes much of the money. The new constitution requires that every child be given 12 years of schooling, but does not explain how to do it; the current law requires nine years, but the reality is six for a large proportion of the population. Executives in electronics, computers, banking, brokerage, accounting, auditing, chemicals, export agriculture, and tourism all say they are severely hampered by inability to obtain employees with the necessary education.



Source: Unesco, Taiwan Director General of Budget and Accounting

...means backward
social structure

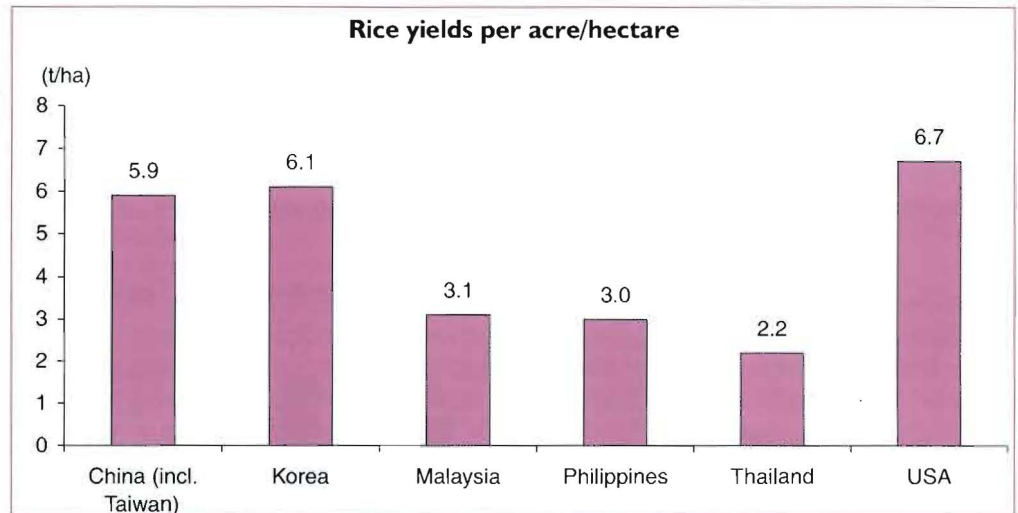
Educational failure has doomed Thailand to a very backward social structure compared with the other fast-developing countries of Asia. The majority of the population still works in the rural areas.



Source: ADB Key Indicators of Developing Asian and Pacific Countries

Agriculture should be
strong but is weak

Within that social structure, it has limited the development of Thailand's sector of greatest and most obvious competitive advantage, namely agriculture. To take only one example, Thailand has long been the world's greatest rice exporter but its rice yields are lower than those of many competing economies.



Source: International Rice Research Institute

Politics causes weak infrastructure

The weakness of Thailand's infrastructure derives neither from lack of investment nor from lack of competent planners, but rather from the political decision-making process. Ministries do not communicate with each other. Projects are endlessly delayed by political quarrelling. Projects are frequently pursued not on the basis of national economic benefit but rather on the basis of how much they can be milked. One need only reflect on the national airline, with its odd combination of different aircraft and engines, to understand why an economy that has grown so fast for so long has failed to build a road network or a telephone system or other infrastructure systems that really work. As the people of Thailand widely understand, the political reforms in the new constitution are the beginning, but just the beginning, of the resolution of the national economic squeeze.

Competitive advantages:

1) agriculture

What will provide Thailand's future growth? The foundation must be agriculture. The pitifully low yields of current Thai agriculture, together with the country's prominence in global food production despite those low yields, underline a great opportunity. Education, consolidation of agricultural plots, and addition of value-added production can provide enormous growth. Demographic changes will facilitate consolidation.

2) regional manufacturing, autos, white goods, machinery

The success of Thailand's automotive industry deserves special attention as a template for potential successes in the future. Thailand has succeeded primarily because it is less protectionist than its neighbours and provides a level playing field for foreign direct investors. Unlike Indonesia, the rules are clear. Unlike South Korea, foreigners are not deliberately driven out. Unlike Vietnam, there is no necessity to spend years building a consensus among government and party officials. Unlike Malaysia, Thailand does not insist that all key parts of the car be made at home. This latter difference saves Thai auto producers from, for instance, the huge inefficiencies of having to make axles (which normally require a production run of at least 500,000 to be efficient) for a limited market. Since Thailand is not protecting a national car, like Malaysia's Proton or Indonesia's Timor, it has attracted most of the key automakers (Ford/Mazda, Isuzu, Toyota, General Motors, Mitsubishi, and others) and has developed a large industry of Thai companies supplying auto parts and providing services. Thailand's large, partially educated workforce can compete successfully against Malaysia's small workforce, Indonesia's uneducated workforce, and South Korea's very expensive workforce. Having a large domestic market helps, and so does having a long history in the industry (assembly started in 1962), but the principal keys to success have been openness and fairness.¹²

¹² Honda recently moved to the Philippines, and there is widespread fear that the Philippines, with a better-educated workforce, will attract other firms.

Air conditioning and white goods could enjoy the same kinds of success that vehicles have. High-quality consumer goods are also a promising product range for Thailand's future.

3) financial services?

Ironically, given its current weakened state, Thailand's financial services industry could become a great source of competitive advantages in the future. Unlike South Korea, Thailand has had real banks for a very long time. Whereas South Korean banks mostly just handed over money to a small number of conglomerates according to government instructions supplemented by bribes, Thai banks have been making real credit decisions about a multitude of fragmented customers for decades. Bangkok Bank, along with Hong Kong's HSBC, is the financial reactor core of the overseas Chinese business network in Asia. Thai banks should be much better positioned than Hong Kong and Singapore banks to finance much of Vietnam, Cambodia, Laos, and Burma, and the future will likely bring vast opportunities for expansion into southern China. Although Thai banks are currently shrinking, debt-equity swaps should eventually give them far greater influence over the Thai economy. If foreign banks are allowed to team up with Thai banks, and to control fully some banks, then Thailand's banking industry could become vastly more competitive and influential; Hong Kong dominates the region precisely because it is so open and competitive. But Thailand may limit the number of steps it is willing to take in this direction. As of now, foreign banks can enter and hold positions for a decade but not participate in any future capital increases; that will vastly reduce the attractiveness and price of Thai financial firms to foreign companies, and will limit Thailand's ability to develop as a regional financial powerhouse. If Thailand takes its financial medicine, the recovery and reform process could create a vast modern industry much more valuable than petrochemicals or steel.

In sum, Thailand is recovering and has enormous opportunities. But we do not expect a return to sustained 8% growth any time soon. Thailand will succeed to the extent it follows through on financial and legal reform, focuses on educating its people, makes its industries more competitive by eliminating excessive protection for petrochemicals, refining and steel, and cleans up its corruption.

The Thai crisis in larger perspective

In 1997, at the height of the economic crisis, Thailand effectively declared a time-out and focused on passing a new constitution designed to replace the current system of governance by businessmen trying to use political office to make money with a new system with real politicians and real parties. To understand why this preoccupied Thailand at the height of a financial emergency, one has to view Thailand in the 1990s as a comprehensive system that has gradually broken down and is in the process of being rebuilt. In the broadest terms, the financial crisis is one aspect of a broader crisis of the Thai regime, the Thai political-economic system, in the 1990s. This was not clearly articulated or explicitly analysed at the time, but it was deeply felt, and this intuitive understanding is profoundly auspicious for Thailand's future.

The Thai Cold War system

Any attempt to characterise the Thai "system" is a still photograph of a moving target, but the way Thailand worked from the 1950s through much of the 1980s had relatively coherent patterns and relatively stable institutions. We sketch in a few sentences on what has been the subject of numerous lengthy books.

*Old politics based on
military-civilian
competition...*

Cold War Thailand was ruled, competitively and in alternation, by a military elite and a growing cluster of democratic political parties. Both sides in this competition employed what was by third-world standards of the time an exceptionally competent and prestigious civil service. The military ruled until its excesses of repression and corruption alienated the public. Then the democratic parties ruled until socialist rhetoric, public disorder, inflationary economic mismanagement, and corruption alienated the public. As the competition between these alternate forms of government heated up in the early 1970s, the King emerged as the moral arbiter and the most sensitive barometer of national opinion. This re-emergence of a revered and influential King 40 years after the military overthrow of the monarchy in 1932 swam against the tide of global history but was decisive in stabilising and unifying contemporary Thailand. The Buddhist hierarchy, effectively organised as an adjunct of the civil service, not only set the moral tone but also concretely organised a critical margin of Thai life; every boy was supposed to do his time as a monk, and even senior figures who had fallen from grace withdrew to the temple to restore their personal equilibrium and cleanse their public image. The banks, owned mainly by Chinese-Thai businessmen and dominated much of the time by Bangkok Bank's Chin Sophonpanich, disciplined and directed business to a degree that has never been adequately recounted. The military leaders were drawn into business alliance with the Sino-Thai bankers, and were greatly enriched by them but at the same time deeply resented their power; coups of the 1980s were frequently accompanied by anti-Chinese banker manifestoes. Private enterprise was identified with the Chinese and therefore was perceived negatively, while state enterprise was seen as being in the public or native Thai interest. Most of society was rural, outside the elite games just described.

*...disciplined by the King
and religion*

...and banks

The system worked...

This system had noteworthy balance and discipline in comparison with other third-world societies. The military-banking-civil service alliance kept Thai society more docile and more conservatively financed than most third-world countries, and this accounted for Thailand's avoidance of the Latin America syndrome of interest group dominance, inflationary budgeting and periodic financial crisis. As noted at the beginning of this report, the Thai system was more inclusive than its counterparts in the Philippines or Argentina or South Korea and was therefore less prone to revolutionary upheaval. Even rural society had more widespread land ownership and was therefore less prone to class-based upheaval than China or Cuba or the Philippines. Despite the residual Sino-Thai frictions, relations between the indigenous Thai and the Sino-Thai were most notable for intermarriage, Sino-Thai adoption of Thai names, and interlocking interests. The civil-military competition, mediated by the King, was smoother than elsewhere, and Thai Buddhist tolerance permeated everything. Firm limits were set

by the institutional skeleton of the system: the King, the Buddhist hierarchy, the bureaucracies, the military, and the bankers. This was a very elitist, hierarchical society.

Breakdown of the Cold War system

*...but each element
experienced
obsolescence*

As Thai society developed, each element in the Cold War structure gradually became transformed until the old system was obsolete. Economic progress brought the rise of a Thai middle class and an ethnically Thai entrepreneurial business elite. The expanding middle class gave more and more clout to the democratic political parties at the expense of the military and the bureaucracies.

*The military switched
from saviour to exploiter*

Development also brought with it a complex economy. Increasingly, there developed a group of civilian technocrats, with roots in the middle class, who could manage the economy competently without the periodic discipline of military intervention. Increasingly, the economy was too complex for the military to intervene and quickly sort out civilian mismanagement. To the extent there was a clear break-point, it came in 1984, when the civilian technocrats and the prime minister knew the country needed a devaluation but the army, led by General Arthit as point man for a group of vested interests, demanded that the currency be held stable. General Arthit went on national television to denounce the prime minister's plan, and the national crisis faded only when the king invited Prime Minister Prem to the palace and allowed pictures to be taken showing them conversing in their pyjamas. From this point onward, the roles of civilians and the military reversed. The civilian technocrats became the advocates of sound policy, and the military became a collection of vested business interests. This reached its peak in the late 1980s under General Chavalit, when the army generals controlled all business relations with neighbouring Cambodia, Laos, Vietnam and Burma; controlled economic development funding in much of the country; and sat astride the vast flow of funds for weapons purchases, aircraft purchases for the national airline, and much else. The vast private funds accumulated in that era still undergird some of today's political parties. The central symbol of that era was the Burmese Army, historically Thailand's greatest enemy, being allowed to come inside Thailand, killing some Thais, in order to outflank the Karen tribal army in Burma and gain access to Karen teak in order to close a vast teak deal between Thai and Burmese generals.

*An export-oriented
economy weakened the
bureaucracy and state
enterprise roles*

At the same time, development began to break down the rationale for the bureaucracy and the army to control so much of the national economy. The economic crisis of 1984 was a crisis of import substitution industrialisation; the inward-looking economy simply could not grow any more. The regime switched to a more open, export-oriented, foreign investment-friendly policy and enjoyed a great boom for the next dozen years. Simultaneously the rise of an indigenous Thai business elite and middle class took much of the heat out of Thai resentment of Sino-Thai business pre-eminence; this deprived the army and the bureaucracy of much of the rationale for state control of much of the economy. Today's residual defence of the state enterprises is the last reactionary gasp of that elite trying to defend its privileges against the tide of history. Socialist ideology faded in the universities and the democratic parties, and this too deprived the army and the bureaucracy of some of the rationale for state/elite control of vast sectors of the economy. The end of the Cold War and the end of socialism in China removed the last piece of the old anti-socialist, anti-Chinese rationale for the military's role in the economy.

The bureaucracies' role also weakened. Under the control of a dictator, or under an elected parliament with a military figure chosen as prime minister, the powerful bureaucracies had functioned in a reasonably coordinated fashion. In contrast, under a structurally weak prime ministerships, with the ministries controlled by competing parties that were determined to keep their deals and bribes secret, coordination and communication often broke down completely. Under the threat of a Cold War, and in an economy where most businesses were relatively small and struggling, the best of the elite joined the government, but in the late 1980s and the 1990s, the trend has

been for the best to abandon government and seek their fortunes in the private sector. The Cold War sense of crisis had given the senior bureaucrats the prestige of saving the nation from the communists, but now prestige came from economic growth and personal wealth. And the formerly advanced bureaucracies started to have trouble keeping up with the times. The BoT gets 247 pieces of paper from each bank each week and lacks adequate systems to manage them. The police have no training or system for dealing with complex commercial crimes, so culprits walk free for years without being tried. The alliance with the military faded, and multiple alliances emerged with powerful business groups.

Financial liberalisation undermined bank hegemony

Gradual financial liberalisation slowly deprived the Sino-Thai banking elite of its control over the flow of funds. This trend came later, primarily in the 1990s, symbolised but by no means confined to, the BIBF. As one leading scholar said, "Until the 1980s there was corruption but under bankers' rules. With liberalisation, the influx of foreign money destroyed the banks' control over their clients." For the first time in history, widespread financial mismanagement became a core problem of Thailand. The great financial debacle of 1997 made clear that the formerly cosy interests of businessmen and bankers were diverging; instead of being part of one big family, and treated by family, the bankers and businesspeople would henceforth introduce more and more arms-length procedures into their relationships.

The Buddhist hierarchy's public position weakened

Even the beloved Buddhist hierarchy and monarchy find themselves in changed times. The monkhood has suffered a series of debilitating scandals. Now it is the Dhammakhaya Temple, led by a monk, Dhammachayo, who personally accumulated vast amounts of property intended for his monastery and apparently initiated girls as novices at the temple. At the beginning of the decade it was a scandal over a movement called Santi Asoke and the defrocking of a monk called Phra Bodhirak. More generally, although the religious reverence for Buddhism continues to pervade Thai life, the emergence of a secular society has eroded the institutional standing of the hierarchy.

The monarchy's role is changed by its extraordinary success

The King has played an absolutely decisive and uniformly positive role in maintaining Thailand's political stability and economic progress for the last generation. In 1973, he intervened to expel an unpopular military dictatorship and validate student demonstrations demanding democracy. In 1976, after that democracy lost control, he backed a military intervention. In both cases, he sensed the mood of his people and the needs of his country correctly. In 1984, he backed the prime minister against a self-interested army chief in a vitally needed devaluations. In 1992, he helped oust a selfish military clique that had shot many student protesters, and in 1997 he helped pass the new constitution over the opposition of General Chavalit and his supporters. But the King has begun warning that the country cannot rely on him forever. He has suffered from heart problems, bleeding haemorrhoids that required a transfusion, and a fall that damaged his spine. The King will likely go down in history as one of the most benevolent and beloved rulers of the modern age, but he himself has emphasised that he cannot indefinitely save Thailand from its excesses. His successors will necessarily play a diminished role. While many of the controversies that once surrounded the succession of the Crown Prince have been resolved, the historical situation is different now. A wise King has nurtured his child, his country, and is now telling the child to stand on its own feet.

Political parties face new demands

In the 1970s and the 1980s, all the democratic parties had to do was to stand for democracy, and that was enough. This was true through the government of Prime Minister Prem Tinsulanonda (1980-88). The democratic parties held elections and praised democracy. Prem, a retired general who held no elected office but was ratified by the legislature, ran the country with proper deference to the expressed feelings of the electorate and a technocrat's concern for sound management. This was the golden age of Thailand, the ultimate expression of the Thai Cold War balance of technocracy and democracy.

The old form of party politics became increasingly discredited. In the old days, it was

been questioning a system in which almost all campaign funds are raised through bribes to ministers. The problem in Thailand has never been that there was a margin of corrupt funding; instead, aside from money of their own that candidates spend on themselves, the problem has been that it is virtually all corrupt funding. Moreover, candidates frequently join or change parties because they are paid to do so. Unlike in the US, where interest groups donate money to pay for a candidate's media campaign, in Thailand the common practice is to make a payment to the budding politician and to pay the market price for the required number of votes to get that candidate elected in some available district.

The new democracy had a party...

By 1988, the country wanted real democracy, and it elected another former general, Chatichai Choonhavan, to inaugurate real democracy. The result was like a matron taking her girdle off. All the constraints vanished. Thailand had a party. All the excesses of an electoral system financed by vote-buying and ministerial payoffs came to the fore, and many of the elitist constraints vanished. This was the era of the billion dollar bribe. In order to hold together a six-party coalition, each major interest group was allowed to feast. The army was no longer even required to inform the prime minister's office about its major operations and policies; it became a business conglomerate. Chatichai also inaugurated toward Thailand's neighbours a policy of "Turning the battlefield into a marketplace," which under the cover of a fine post-Cold War slogan gave the army carte blanche to become a business conglomerate with monopoly positions and a right to squeeze nearby countries mercilessly. The scale of corruption so appalled the Thai public that there was near-universal concurrence with an army coup in March 1991 that installed a non-elected prime minister, Anand Panyarachun, a career civil servant and businessman with an aristocrat's air and a focus on the good of the nation. Anand's personal probity and attack on corruption made him a national hero. That same probity led him to step aside as quickly as possible in favour of an elected prime minister.

In the ensuing 1992 election, a military clique based on Class 5 of the military academy determined to retain real power, and its manipulation of the election led to violent, public protests, which the army brutally suppressed in a Thai counterpart to Beijing's Tiananmen Square debacle. Public revulsion forced out General Suchinda Krapayoon, and Prime Minister Anand came back for three months to clean up the mess.

...and a serious hangover

The early 1990s left the Thai public disgusted with both military excesses and democratic party excesses, but did not lead to a broad system change. The military was totally discredited as a political player, and it would take total national collapse or a major international war to gain public acceptance of a military return to power. There was equal public disgust at civilian government corruption, but no theory of how to fix it. The first government of Chuan Leekpai, September 1992 to May 1995, was a reaction against the corruption and militarism but came across as a naïve and impotent government by a Thai version of Jimmy Carter. There followed a return to the mold of the past: an interest-group-ridden civilian government under businessman Banharn Silpa-Archa for barely more than a year (July 1995 to September 1996) and then the democratic election of the general, Chavalit Yongchaiyudh, who had presided over the army during the period of the greatest military excesses as a business conglomerate, during the corruption of the Chatichai years. Chavalit came to power in November 1996 and his government presided over the total expenditure of Thailand's previously well-endowed foreign exchange reserves, and the baht and banking system collapse of mid-1997. The property bubble, the business and banking excesses, the political party system that treated government power as an avenue to business enrichment, and the role of a military that had become a private business and a purchaser of political power, all came together.

The politically active Thai public looked at this spectacle and decided it needed a new system. Although it is seldom articulated so bluntly, Thailand effectively decided that the economy could not be fixed until the political system was at least partially fixed, and that what needed to be fixed in the political system was mostly corruption.

An emergent new system

Each element of the Thai system is being re-cast as a new, more modern system emerges.

A less elitist, anti-corruption constitution

New constitution. A constitutional commission chaired by former Prime Minister Anand, second only to the King among Thai symbols of probity, proposed constitutional amendments in the fall of 1997. General Chavalit's government opposed them bitterly, with the Interior Minister at one point accusing supporters of the new constitution of being communists. Taken literally, the accusation was ludicrous, but it accurately reflected terror at the challenge to elitist rule, at the emergence of a new order. The Chavalit government was displaced by a new Chuan Leekpai government in November 1997, and the lower house passed the constitutional amendments in May 1998.

The new constitution replaces an appointed Senate dominated by military officers and plutocrats with a purely elected Senate, but with senators who may not campaign or join political parties. It bans elected politicians from holding ministries, thereby seeking to curtail the habit of funding campaigns through bribery. It requires that ministers have at least a bachelor's degree, thereby excluding many current ministerial candidates. It forces politicians and parties to make their finances public. It provides for broad freedom of information and it gives the Senate the right to remove elected politicians, a potentially lethal combination for graft-ridden political leaders. Elections will be organised by an Election Commission rather than by the Interior Ministry. (Having the corruption-ridden Interior Ministry in charge of elections and the police was an appropriate symbol of the problems of Thai democracy under the old constitution.) It makes it difficult for officials to check whether voters actually voted for the candidate who paid for their votes.

The King played a vital, although as usual quiet, role in getting the new constitution passed. To the extent the new structure is implemented, he will have fulfilled his role in bringing his child to maturity and setting it on its own adult feet.

Thai military leadership seeks professionalism

Military professionalism. Since Thailand's 1992 blood-letting, the military has withdrawn into a much more limited political role. In 1997 big demonstrations occurred and General Chavalit effectively invited the army in, but the invitation was ignored. The new Commander in Chief under Chuan has emphasised withdrawal from politics. He pointedly resigned his Senate seat. He has refused to handle relations with Burma, Laos, and Cambodia — an authority that allowed General Chavalit to accumulate much of the political warchest that funded his later election as prime minister. The military has accepted drastically reduced military budgets and dilution of its ownership of Thai Military Bank. This does not mean that nirvana has been achieved; the military remains heavily engaged in a wide range of businesses from Thai Airways to illegal logging. But the direction of change is clear and the accomplishments have been major. The Thai army is being changed from a business conglomerate into a modern professional army.

The Democrats are a new kind of party

New parties. The Democrat Party under Chuan Leekpai is a new kind of political party, more disciplined, more focused on the task of governing as opposed to feeding. In his new incarnation Chuan himself is no longer a Jimmy Carter figure, but a disciplined, determined leader managing an effective political organisation. As with the army, it is far from having fully escaped the habits of the old system, but its organising principles are sufficiently different that its coalition partners and opposition are right to be terrified that, if this party stays in power too long, the old ways of doing things are going to change forever.

The Buddhist clergy will continue to set the moral tone of the world's most religiously influenced societies, and one of the societies most positively influenced religious societies, but their role will be more moral and less organisational, and their practices will be subjected to a far higher degree of public scrutiny than ever before.

Banks are joining the modern world

The new banking system will be much more competitive, much more open to foreigners, much more arms-length than before. Of course, long-time business associates will still get favoured treatment, but the balance sheets will be looked at, often by a committee rather than single autocratic individual. This will open up Thai society and create opportunities for emergence of new groups and new businesses much more rapidly than before.

Civil service and state enterprises face new demands

The civil service and the state enterprises will never regain their former prestige, but they will gradually be streamlined and modernised in ways that are parallel to what is happening in the army. The universities will become autonomous, whereas now they are part of the civil service, and this will lead to a further opening of intellectual life and a weakening of the hold of government on society. **The freedom of information laws** are going to cause a revolution, albeit a gradual one, in the way all parts of society function. The universities, the nursery schools, the ministries, the political parties, and the banks and businesses all are going to be changed.

Freedom of information will change every institution

None of this will happen quickly. As the sometimes enervating detail on the progress of Thai restructuring shows, everything is going to be done the Thai way, which means gradually, piecemeal, and with all sorts of shenanigans. Moreover, there are risks. The reactionary elements have enormous amounts of money, and they still occupy important positions in politics, in the bureaucracy, in business, and in banking. (The clearest thrust into modernity has come in the military.) If one looks at the details, particularly if one looks at the details in the shadow of the ongoing crisis, one becomes immensely discouraged. To take one example, a leading journalist argues that the coming Senate election will probably be the most corrupt in Thai history — because the system is new and, like a new model of car, will have lots of unexpected problems. But he goes on to argue that the new system will nonetheless function much better over time.

Change will be messy

The crisis of 1984 illuminates aspects of the present crisis. Thailand in the early 1980s had painted itself into an economic corner with a failed policy of import substitution. It faced a currency crisis, a potential foreign exchange shortage, a civilian military confrontation, and serious corruption. A few key decisions and a variety of marginal changes ignited a dozen years of exceptional growth and gradual political progress.

New system attacks old vices, strengthens Thailand's virtues

The social and political changes occurring address the greatest weaknesses of Thai society, particularly corruption and elitism. They also strengthen all the old virtues. Thai society always had more freedom of information than its neighbours; now there will be much, much more. Thai politics was always more inclusive than its neighbours'; now it will be more inclusive. The Thai economy was always more diverse and competitive; now it will be far more competitive. Thais have always dealt more easily with foreigners than Koreans, Indonesians and Malaysians; now Thai advantages will be enhanced. Thais have always handled social and political change more smoothly than most of their neighbours. When one compares the gradual and mostly civilised change occurring in Thailand with the upheaval in Indonesia, the jailing of Anwar in Malaysia, and the jailing of two earlier presidents in South Korea, one sees that the Thais are once again displaying superior balance.

To the financial analyst, the immediate reaction to the national focus on political reform is negative. Why don't they focus properly on imposing changes on the banks? But the Thai system was cracking up, and fixing the system is not a diversion. Thailand's broader changes translate directly into economic advantage. Structural economic improvements are coming, and if they come in the back door of politics and are called "freedom of information" rather than "transparency," they are nonetheless improvements, and very broad-based ones. In economics, the one grows not by changing night into day but by improving at the margin. Thailand is improving all sorts of margins. One of the consequences, if even our relatively modest economic forecasts prove correct, should be an explosive improvement in corporate profits. The Senatorial elections early next year should add to an atmosphere of hope and progress. There are risks, but there always are. Thailand is coming back.

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